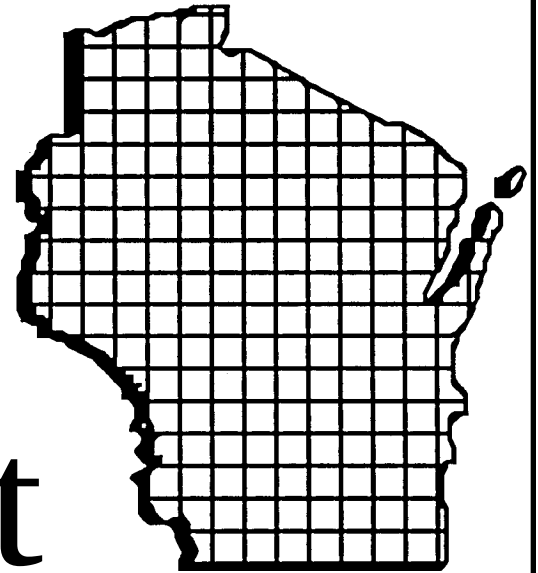


Wisconsin

Policy
Research
Institute

Report



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**Reforming
Wisconsin's
Budget for the
Twenty-First
Century**

REPORT FROM THE PRESIDENT:

Budgets. Pension Plans. Health Care Costs. Governmental administrative problems that were, for too long, overlooked by the public and the media. Over the last several years we have learned, to our dismay, that these seemingly boring topics are beginning to play havoc with Wisconsin's future. As the State of Wisconsin faces a monumental deficit for its next budget, we asked George Lightbourn, who has spent 25 years in state government with the last three and one half as Secretary of Administration, to detail exactly how Wisconsin got into this fiscal mess, and what the future holds once the current biennial budget is balanced.

This report, which is as good a primer as you are likely to see on how state government is financed, paints a picture far different than most of us believe. Simply put, our current budget problems are likely to be repeated time after time over the next decade unless there are serious changes made by the Governor and the Legislature during the current budget process.

While it is certainly true that Wisconsin's fiscal plight today shows very little difference from most other states around the country, there is something else involved. Unlike other states, Wisconsin never established a rainy-day fund. While Lightbourn avoids the obvious, politics played an enormous part in this situation. Spending was never controlled while taxes were cut. It was similar to what happened at the federal level in the early 1980s under President Reagan. The difference is that, unlike the federal government, states are constitutionally bound to run a balanced budget. It was not until the tobacco settlement that it finally began to dawn on most of us that something was amiss in Madison.

It is also clear in this study that state government in Wisconsin works on an extremely short-term schedule. Little is done in terms of long-term planning and, unless the current Governor and Legislature have the fortitude to ignore the next several elections and concentrate on Wisconsin's long-term future, our current budget blues are likely to become a long-term nightmare. For anyone who is seriously interested in government, this report really describes the ways that various problems can evolve into a debacle.

Finally, this study reminds us of a political fact of life. Politicians, whether Democrat or Republican, liberal or conservative, will always spend more unless the public demands otherwise. Simply put, Wisconsin has spent far more for too many years than it could afford. We are now about to pay a serious price. The real question is whether that price is short-term or long-term.



James H. Miller

WISCONSIN POLICY RESEARCH INSTITUTE, INC.

P.O. Box 487 • Thiensville, WI 53092

(262) 241-0514 • Fax: (262) 241-0774

E-mail: wpri@execpc.com • Internet: www.wpri.org

REFORMING WISCONSIN'S BUDGET FOR THE TWENTY-FIRST CENTURY

GEORGE LIGHTBOURN

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EXECUTIVE SUMMARY

All eyes in Wisconsin are on the state budget. It is well understood that the state faces a \$3.2 billion budget deficit, the largest in state history. It is also fresh on the minds of the electorate that commitments have been made to solve the problem without a tax increase. How might that be achieved?

The answer is yet to be revealed, but the budget will get done, just as it gets done every two years. This time the budget will likely include a mix of spending cuts, one-time funding, exotic borrowing plans, tuition increases, maybe a cigarette-tax hike, and a few other creative finance ideas.

But then what? What are the prospects for future state budgets? That question is the focus of this study. It looks under the hood of the state-budget process to examine the causes of the current deficit. The root cause of the problem is shown to be an approach to budgeting that is fundamentally flawed. Budgeting in Wisconsin is based, not on a long-range sustainable plan, but on short-term revenue forecasts that are inherently inaccurate. Sound budget principles are often finessed so that budgets will balance in the short run. Danger signs pointing to fiscal trouble are either not recognized or ignored. Quite frankly, a small business using the level of fiscal planning used in the Wisconsin budget would have difficulty obtaining a loan from a local bank.

This study outlines the origins of the current budget dilemma. It examines the phenomenal revenue growth of the 1990s, taking note of warning signs. It looks at spending initiatives and tax cuts from that decade. State budgets then were able to take on and conquer almost every major issue of the day, and the money was there to make it possible. In the short run, all was well.

But now reality has set in, and this study outlines a number of hard lessons that have been learned. Among the lessons are that state tax revenues are volatile, and state spending — while more predictable than revenues — always goes up. Also, Wisconsin's balanced-budget requirement provides only the illusion of fiscal prudence. The tools needed to fix the budget process are missing. Worst of all is that Wisconsin cannot grow its way out of its current problem. Even with the type of revenue growth experienced in the 1990s, Wisconsin could face a \$1.5 billion short-fall in the 2005-07 biennium.

The Governor and the Legislature must take action. They must first produce a budget for the next biennium using the traditional tools. However, once that is done, they must turn their full attention to tackling the equally important issue: How will Wisconsin avoid this problem in the future?

This study makes a case for overhauling and modernizing budgeting in Wisconsin. No one would invest in a business that uses the fiscal planning procedures and controls used to balance budgets in Wisconsin. Doing so would exceed the risk tolerance of the most venturesome investor. Yet many programs that are critical to millions of citizens depend on Wisconsin's precarious budget. The undependable nature of the state budget jeopardizes Wisconsin cities, schools, businesses, services to the most vulnerable citizens, and future economic growth. If the Governor and the Legislature fail to address long-range budget issues, the result will be more fiscal uncertainty in the future, and maybe even that tax increase nobody wants.

Feast-or-famine budgeting is unhealthy, and is avoidable. But dealing with it will require significant changes. Small changes will not do. The Governor and Legislature must establish a long-range bottom line for state spending. How much can Wisconsin afford over the long run? If spending is too high, a lower, more sustainable bottom line spending plan must be developed. This long-range plan would set global spending targets, leaving the allocation of resources to specific programs to be decided in future biennial budgets.

This study does not recommend a particular bottom line for state spending. It notes that, in the mid-1980s, the Expenditure Commission, appointed by Governor Earl, suggested moving state and local spending to the U.S. average of spending per \$1,000 of personal income. That would be a logical place to begin the discussion. Using the latest information (1999) that bottom line would require that state and local spending in Wisconsin be reduced by \$2.4 billion. Regardless of what bottom line is ultimately set, it is critical that legislation be passed before the end of 2003 in order that the next biennial budget can be built around it.

Further, the bottom-line spending plan needs to have teeth. Future budgets must be required to be built within the parameters of that bottom line, instead of building them using only short-term revenue forecasts as they are now. This would be a key step in modernizing Wisconsin's budget process, a process that has gone unchanged since the 1970s. Other improvements would include establishment of an Economic Council and restrictions on the use of one-

time revenue, and provisions for funding a budget reserve. Wisconsin's financial management must be updated to new circumstances, just as any business is expected to update and modernize its financial systems.

No one needs reminding that this is a critical time for Wisconsin. Long-term budget sustainability is not merely something for the good-government types and the academics to debate. It is a real problem that cannot be passed on to the next legislative session. The politics and the policy discussions around the topic of long-term budgeting must be dealt with this year. If the problem is passed along to the next session of the Legislature, Wisconsin should brace itself for a repeat of the current budget turmoil in the near future.

INTRODUCTION

Wisconsin state government is facing the most significant financial challenge in its history. The state budget is out of balance by \$3.2 billion. The irony here is that the crisis comes close on the heels of the 1990s, when state government seemed able to do anything. That was the era of elevated spending, new programs, and tax cuts – something for everyone. In the wake of that period of prosperity, the new century has brought fiscal famine to Wisconsin.

The current budget shortfall will require the Governor and the Legislature to make deep cuts that will affect nearly every citizen. One would never have imagined a problem of this magnitude a few short years ago, when the economy was robust and state government seemed able to attack nearly every problem with a new spending initiative. The feast-or-famine nature of Wisconsin's budgeting practices is extraordinary and stands to disrupt the lives of millions of citizens.

Recovery will entail two steps. Step one requires balancing the budget in the short term. As this paper is being written, the Governor and the Legislature are in the process of making the difficult decisions needed to bring spending back within the bounds of expected revenues.

Step two will require significant changes in the way Wisconsin goes about the business of budgeting. That broader issue is the focus of this study. It examines the budget system that has yielded Wisconsin's feast-or-famine budgeting cycles. Where are the roots of the problem, and what are some of the lessons that we should learn from this experience? And, most importantly, what changes should be made to ensure that future citizens are not subjected to more feast-or-famine budgeting? If step two is not taken, we will undoubtedly see another budget deficit within a few years.

This study will show that Wisconsin's budget deficit is the result of three events: the softening of the economy which began in 2000; the reduction of personal income tax rates that went into effect in 2000; and the elevated spending level left over from the 1990s. Had any one of these three events not occurred, there would be no shortfall today.

The fact is that all three did occur, creating a perfect budget storm. And unless fundamental changes are made in the way Wisconsin prepares budgets, the same result will occur again and again.

BACKGROUND

It is of little comfort to the public and the elected officials who are charged with balancing the next budget to know that 46 other states have significant budget problems.¹ States share a common flaw in budgeting in that fiscal planning rarely extends beyond the term of the upcoming budget. When there is a downturn in the economy, all the states face the same crisis.

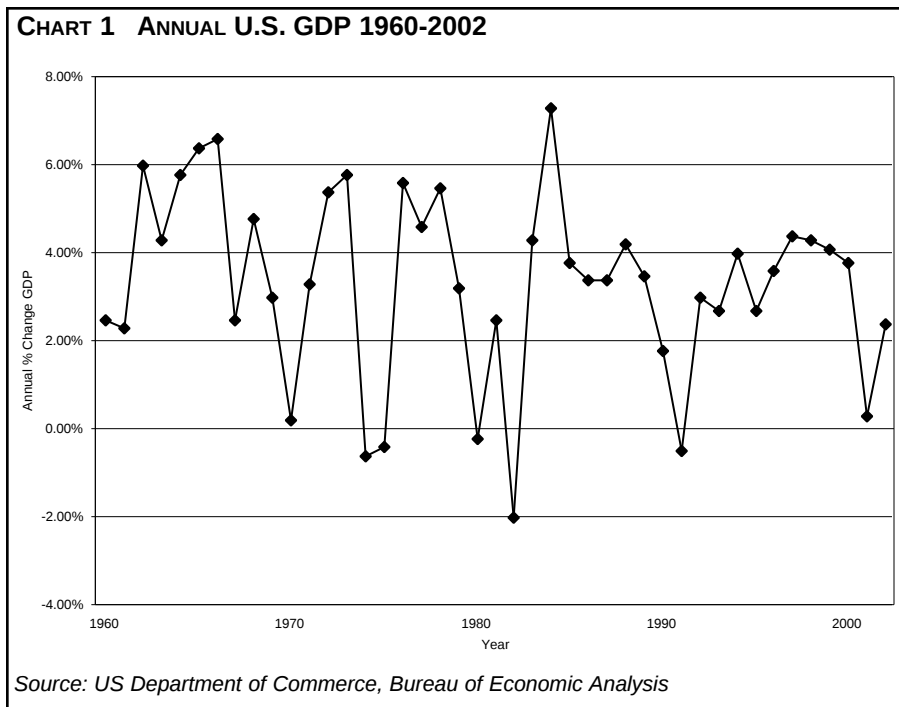
There is no shortage of comment on Wisconsin's problem. Editorial writers, elected officials, and citizens all note how the state spent too much and used gimmicks to balance previous budgets. All say that it is time to operate state government in the way that prudent adults handle family finances. The most common theme is that state government must live within its means.

This budget problem has already injected uncertainty into the lives of millions of citizens who depend on state government in one way or another: the person receiving medical assistance, the small-business owner, the construction worker, the senior citizens who have only recently begun having their prescription drug costs subsidized. The severity of the problem will almost certainly affect all these people and several other groups. What is really at stake is what makes Wisconsin the type of place in which the state's citizens take pride.

A basic premise of this report is that Wisconsin government needs the capacity to deliver a reasonable level of services to its citizens through economic ups and downs. But under our current short-term approach to budgeting, state government can be counted on only when the economy is boiling.

What is somewhat puzzling is the severity of the budget problem. While it is true that Wisconsin's economy is sluggish, by historic standards this downturn is rather mild. As noted by Curt Hunter, Senior Vice President and Director of Research for the Federal Reserve Bank of Chicago, "the economy slipped into a recession in March 2001, with GDP falling during the first three quarters of 2001." But, Hunter continues, "the 2001 recession . . . was mild compared with other recessions,"² and it was short-lived. Where would Wisconsin state government be if it had been hit with a deeper recession like the one experienced in 1972-74?

Chart 1 shows annual changes in U.S. Gross Domestic Product (GDP) from 1960 to 2002. The cycles of the nation's economy become apparent. The decade of the 1990s was a time of sustained economic prosperity. Then came the decline in 2001 and the slight, slow recovery of 2002. Yet the softening of the economy in 2001 and 2002 would hardly suggest a budget deficit in Wisconsin totaling \$3.2 billion. Citizens expect their government to be able to deal with a mild downturn without having to resort to tax increases or to draconian spending cuts. Yet that is what is currently facing the Governor and the Legislature.



It is unfortunate, and a bit odd, that when state revenues are abundant, little attention is focused on the sustainability of budgets. It apparently takes a crisis to force a public discussion of how to budget through a longer cycle that will include good times and bad.

As a society we are quick to ask who is responsible. In the case of the state budget deficit, there is no simple answer. We cannot lay responsibility at the feet of past governors or legislatures. We can't blame the Democrats or the Republicans.

The key problem is not the budget process, or a lack of revenues, or even profligate spending. It's not

caused solely by school aids, Medicaid, reduced class size, or the cost of prescription drugs. And it is not caused solely by tax cuts, tax rebates, one-time revenues or accounting gimmicks used to balance past budgets.

While all these factors have helped pave the way to the current budget problem, none is solely responsible. This report places blame for the budget problem at the feet of shortsighted and inadequate fiscal planning. Wisconsin's Constitution, like that of every other state, requires a balanced budget. And, while it is arguably prudent to require that expenses do not exceed revenues, that requirement also fosters myopic fiscal planning. Wisconsin's fiscal planning horizon is two years, and we start over again at the beginning of each biennium. Budget after budget has been carefully, painstakingly constructed to ensure that state government would stay within the corral of the constitutional balanced-budget provision. Over the past several years, however, each biennial budget, while balanced, brought us one step closer to the current fiscal precipice.

That outcome has been caused partly by the state's outdated constitutional and statutory requirements and partly by increased politicization of the budget process. More than one budget has been riddled with items of pork. However, the current problem far exceeds anything created by including particular items of pork in budgets. More generally it reflects officeholders not wanting to deny or defer initiatives, fearing negative consequences at the ballot box. Elected officials tend to have long lists of things they want to accomplish in office. These usually include spending items and tax cuts. Few officeholders place creating a budget reserve high on that list. More than one political expert has put finances in a place below politics in constructing budgets. This was articulated most clearly by an anonymous political advisor who, in considering a new spending proposal, stated "of course this initiative will make the budget worse. But it's important that we be around to fix it next year."

To understand how the budget got so far out of balance requires looking back into the budgets of the 1990s; it is there that the current problem was born. This study will move back in time, focusing primarily on spending and revenues in the 1990s, in order to identify the source of the problem and to determine how a similar occurrence might be avoided in the future.

REVENUE GROWTH

To understand the current imbalance between revenues and spending, it is necessary to understand what drove each of the components. There is more than a little irony in the current stagnation of state revenue collections, given the full-bodied growth of just a few years ago. It is the juxtaposition of today's predicament with what we all remember as the good times of the late 90s that makes the current dilemma that much more painful.

The High-Flying 90s

So, how good were the 1990s? For most Wisconsinites and certainly for state government, that decade was a watershed. It was a decade when the personal income of the average Wisconsinite grew by 57 percent.³ This occurred during a time when inflation grew by only 32 percent.⁴ Things were pretty good. Newspapers daily reported on the robust economy and, more importantly, people saw the results in their wallets. People who had never needed to know the difference between an equity and a fixed-rate asset now became active investors.

Further evidence is provided by the record of state tax collections, as shown in Table 1. In 1990, total general fund revenue collections for state government stood at \$5.6 billion. (Compare that to the current deficit of \$3.2 billion.) Within ten years, revenue had grown to \$10.9 billion, **an increase of 94 percent**. The decade of the 1990s was indeed a prosperous decade, particularly for state government.

But the growth of state revenues was not spread evenly among the various components of state collections. As Table 1 also shows, collections from the personal income tax grew by an amazing 127 percent during this time. Sales tax revenues grew by 77 percent, corporate taxes by 48 percent, and all other taxes by only 39 percent.

Clearly state government was becoming more reliant on revenue from the personal income tax to fuel spending. In 1990 the personal income tax yielded 46 percent of total revenues. By 2000 that figure had grown to 54 percent. This growth was not the result of a change in tax policy; only relatively small changes had been made to the income tax code in the 1990s. Instead the change reflected growth in the wealth of Wisconsin (which was accentuated in state revenue collections by tax tables which were not indexed for most of the decade). This point, while hardly profound, does become significant in explaining the current deficit.

Table 1 shows that revenue collections in the 1990s were marked not only by growth, but also by volatility. Year-to-year increases ranged from a low of 2 percent in 1990 to a high of 10 percent in 2000. The volatility of personal income tax collections was even more pronounced. Year-to-year growth ranges from a low of 1.9 percent in 1990 to a high of 15.5 percent in 2000.

It is interesting to examine more closely the revenue growth of the late 1990s, when incomes really exploded. Specifically, Table 2 provides information on Wisconsin tax filers for the tax years 1997 through 2000. Over that critical four-year period the adjusted gross income reported by all Wisconsin taxpayers grew from \$88.6 billion to \$106.9 billion, an increase of 21 percent. Examined more closely, the data show that the most significant growth occurred in the upper-income categories.

While overall adjusted gross income grew by 21 percent in that four-year period, the adjusted gross incomes of filers reporting incomes exceeding \$100,000 grew by an astounding 49 percent. This growth reflects, in large part, a swelling in the number of people in this category. In that four-year period, the number of tax filers reporting incomes exceeding \$100,000 grew from 96,394 to 149,998 — an increase of 55 percent.

Contrast that with the adjusted gross income reported by filers earning less than \$100,000. During that same four-year period this group reported an increase in adjusted gross incomes of 12 percent. This is rather modest growth, is largely attributable to the number of tax filers whose incomes increased, moving them across the \$100,000 threshold.

Looking at the data on filers above the \$200,000 level is also interesting. The number of filers crossing this threshold grew by 42 percent during that four-year period. Many Wisconsin families were becoming wealthy.

Let's next look beyond the number of filers and move to the personal income tax revenue generated from those with incomes above and below \$100,000. State tax collections during that period became much more dependent on higher-income taxpayers. In 1997 tax filers with incomes above \$100,000 contributed 28.5 percent of total income tax revenues. By 2000 that group was contributing nearly 37 percent of income tax revenues.

TABLE 1 WISCONSIN STATE REVENUE GROWTH — FISCAL YEAR 1990 - FISCAL YEAR 2000

GPR* Tax Collections (Millions of Dollars)	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	10 Year Growth
Individual Income	\$2,624.90	\$3,003.40	\$3,142.20	\$3,445.80	\$3,638.70	\$3,932.90	\$4,157.40	\$4,544.70	\$5,047.30	\$5,162.20	\$5,962.00	\$3,337.10
General Sales and Use	\$1,983.80	\$2,026.70	\$2,127.30	\$2,260.60	\$2,427.90	\$2,571.20	\$2,704.20	\$2,864.40	\$3,047.40	\$3,284.70	\$3,501.70	\$1,517.90
Corporate Income/Franchise	\$436.60	\$440.90	\$437.70	\$492.00	\$541.30	\$631.80	\$636.00	\$643.80	\$627.00	\$635.20	\$644.60	\$208.00
Other	\$604.30	\$601.90	\$632.20	\$672.60	\$679.60	\$671.00	\$711.90	\$751.10	\$806.60	\$866.20	\$837.70	\$233.40
Total	\$5,649.60	\$6,072.90	\$6,339.40	\$6,871.00	\$7,287.50	\$7,806.90	\$8,209.50	\$8,804.00	\$9,528.30	\$9,948.30	\$10,946.00	\$5,296.40
Percent Change over Prior Year	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	10 Year Growth
Individual Income	1.90%	14.40%	4.60%	9.70%	5.60%	8.10%	5.70%	9.30%	11.10%	2.30%	15.50%	127%
General Sales and Use	5.10%	2.20%	5.00%	6.30%	7.40%	5.90%	5.20%	5.90%	6.40%	7.80%	6.60%	77%
Corporate Income/Franchise	-2.60%	1.00%	-0.70%	12.40%	10.00%	16.70%	0.70%	1.20%	-2.60%	1.30%	1.50%	48%
Other	-3.10%	-0.40%	5.00%	6.40%	1.00%	-1.30%	6.10%	5.50%	7.40%	7.40%	-3.30%	39%
Total	2.00%	7.50%	4.40%	8.40%	6.10%	7.10%	5.20%	7.20%	8.20%	4.40%	10.00%	94%

• General Purpose Revenue

Source: State Budget Office, Department of Administration

TABLE 2 WISCONSIN TAX FILER DATA — 1997-2001 — (\$ IN MILLIONS)

Wisconsin Adjusted Income												
	Tax Year 1997			Tax Year 1998			Tax Year 1999			Tax Year 2000		
WI Adjusted Income (WAGI): Total Amount (\$)	Tax Filers Count	Percent	WI Adjusted Income (WAGI): Total Amount (\$)	Tax Filers Count	Percent	WI Adjusted Income (WAGI): Total Amount (\$)	Tax Filers Count	Percent	WI Adjusted Income (WAGI): Total Amount (\$)	Tax Filers Count	Percent	WI Adjusted Income (WAGI): Total Amount (\$)
Less than \$0	25,846	1.00%	-379,903,276	23,014	0.90%	-358,637,903	25,374	0.90%	-345,586,098	27,331	1.00%	-468,940,619
\$0 - 50,000	2,052,138	78.50%	36,660,816,917	2,035,381	76.80%	36,992,644,808	2,032,336	75.40%	37,096,001,732	2,022,923	73.90%	37,188,852,015
\$50,000 - 100,000	466,203	17.80%	31,197,456,104	502,518	19.00%	33,925,748,467	531,892	19.70%	36,156,009,187	565,500	20.70%	38,730,337,823
\$100,000 - 200,000	73,185	2.80%	9,507,235,307	87,612	3.30%	11,350,121,917	100,215	3.70%	12,973,186,147	117,006	4.30%	15,119,688,445
> \$200,000	23,209	0.90%	11,280,414,805	26,172	1.00%	12,765,168,852	29,349	1.10%	14,030,828,230	32,992	1.20%	15,862,763,074
TOTAL	2,614,735	100.00%	88,645,923,133	2,651,683	100.00%	95,033,684,044	2,693,792	100.00%	100,256,025,296	2,738,421	100.00%	106,901,641,357

Wisconsin Net Tax									
	Tax Year 1997		Tax Year 1998		Tax Year 1999		Tax Year 2000		
WI Adjusted Income (WAGI): Total Amount (\$)	Net Tax: Amount (\$)	Percent of Total Taxes	Net Tax: Amount (\$)	Percent of Total Taxes	Net Tax: Amount (\$)	Percent of Total Taxes	Net Tax: Amount (\$)	Percent of Total Taxes	
\$0 - 50,000	1,544,405,487	33.80%	1,450,496,162	31.04%	1,635,025,778	30.83%	1,220,355,749	24.93%	
\$50,000 - 100,000	1,721,552,173	37.68%	1,768,672,488	37.85%	2,011,721,018	37.93%	1,869,101,244	38.19%	
\$100,000 - 200,000	570,754,008	12.49%	650,752,475	13.93%	770,572,726	14.53%	827,441,035	16.91%	
> \$200,000	732,410,970	16.03%	802,535,072	17.18%	885,888,077	16.70%	977,659,866	19.97%	
TOTAL	4,569,122,638	100.00%	4,672,456,197	100.00%	5,303,207,599	100.00%	4,894,557,894	100.00%	

Source: Wisconsin Department of Revenue

Clearly, significant growth of state revenue in the 1990s was driven by revenue from income taxes — largely from taxpayers earning in excess of \$100,000 per year. Many Wisconsin citizens were reaping the benefits of a robust economy, and state revenue collections grew substantially as a result.

While the revenue rolled in to the state, however, few policy makers were asking what caused the tremendous growth. More importantly, few were asking if the growth was sustainable. Had that question been asked, the answer would almost assuredly been no. The magnitude and rapidity of the increase suggested that this was a short-term phenomenon.

The Softening in 2000

We now know that the substantial revenue growth of the late 1990s was not sustainable. Late in 2000 state analysts began to see the weakening of the economy. It is one thing to read about the bursting of the tech bubble and the resulting impact on the economy in general; it is quite another to see revenue collections dip. This shock was particularly pronounced given the era of growth that immediately preceded it.

Late in 2000 and continuing through 2001, the Wisconsin economy cooled off. As previously noted by William C. Hunter from the Chicago Federal Reserve Board, the U.S. economy was in recession for the first three quarters of 2001.⁵ Wisconsin's economy suffered similarly. Little surprise was expressed among economists. As Professor Donald Nichols of the University of Wisconsin-Madison wrote early in 2001, "What is happening is that the economy is making the awkward transition from a period of unsustainably high growth to a period of lower, but sustainable, growth. Such transitions are called soft landings, though the bumpiness during the transition belies the metaphor."⁶

Oddly, through most of the economic downturn, consumer spending held its own, buoyed by zero percent auto financing and generally low interest rates. However, the manufacturing sector bore the full brunt of the economic slowdown, largely because the industry was working off inventories and some industrial production moved to other countries. Wisconsin was particularly affected by the slowdown in manufacturing, since 26 percent of Wisconsin's economy is manufacturing-related.⁷ In short, the soft landing exposed Wisconsin to the bumpiness that Professor Nichols predicted.

Tax Cuts of 2000

At about the same time Wisconsin's economy took a downturn, state lawmakers reduced individual income taxes. The income tax tables had been largely unchanged from 1986 to 1998. But the 1997-99 biennial budget included a number of changes, including a reduction in the number of tax brackets from four to three and a lowering of the top marginal rate, first from 7.9 percent to 6.93 percent, and then to 6.77 percent. In subsequent legislation the top rate was reduced in 2000 and the other rates were reduced in 2001.

The second tax cut passed in 1999 provided for the restoration of the property tax rent credit in 2000. This popular credit had been eliminated in 1999 when an even more popular \$700 million one-time sales tax rebate was passed.

The timing of these tax cuts was significant. While they were enacted during the height of state revenue growth, the implementation was delayed until tax year 2000 (state fiscal year 2001), the same year when the economy began its descent. The tax cuts had the effect of accelerating the descent.

The reduction to the personal income tax rates included in Act 9, passed in 1999, saved taxpayers an estimated \$300 million in FY2001. The reestablishment of the property tax rent credit saved taxpayers an additional \$319 million in FY 2001. The cumulative effect of these tax reductions, projected through the upcoming 2003-05 biennium, is shown in Table 3. Guided only by the short-term revenue forecast, these reductions were prudent. However, like many of the spending decisions of the 1990s, these cuts were implemented without the benefit of a long-range budget plan and thus, like the spending decisions, contributed to the \$3.2 billion deficit facing state government today. As shown in Table 3, the five-year cumulative effect of the two cuts would be \$3.4 billion; without the cuts, the current \$3.2 billion deficit would not exist.

TABLE 3 TAX CUTS FROM 1999 TO 2001 LEGISLATURE SESSION* — (\$ IN MILLIONS)

Fiscal Year	Income Tax Reform and Reductions	Restoration of Property Tax Credit	Total
2001	\$ 300,100	\$ 319,000	\$ 619,100
2002	347,900	335,000	682,900
2003**	358,700	351,800	710,500
2004**	358,700	351,800	710,500
2005**	358,700	351,800	710,500
Cumulative Total	\$1,724,100	\$1,709,400	\$3,433,500

* Includes only Acts 9, 10, and 198

** Projected

Source: State Budget Office, Wisconsin Department of Administration

REVENUE FORECASTING

The system for forecasting revenue for Wisconsin state government has been in place for many years. The Department of Revenue is responsible for forecasting revenue for the executive branch. By statute, a forecast is required for each even-numbered year on November 20. This sets the stage for the preparation of the Governor's budget.

The analysts at the Department of Revenue rely heavily on an independent, private national forecasting service, Global Insight, Inc., a service used by most of the states. Within the Department, analysts tailor this national model to the Wisconsin economy, trying to get the best picture of personal income growth, consumer activity, the business cycle, and several other key indicators of the state's economy.

This is pretty tricky stuff, made even more challenging by the time horizon for the forecast. Every other November the analysts are required to look ahead past the final seven and one-half months of the current biennium to the very end of the next biennium. That is a forecast period of thirty-one and a half months. Clearly, with such a time horizon, trends are more important than specific estimates. Should we expect growth? If so, about how much? But, since so much is riding on the forecast, the actual numbers become a primary focus. It is the only planning tool used in the state to fashion a budget.

Revenue forecasting is a funny business. Given that forecasters never want to be too far away from the consensus, they tend to lag in picking up trends. Revenue estimates were always too low when revenues were plentiful in the 1990s, and they were too high when the economy began to soften.

The Legislature relies on the Legislative Fiscal Bureau for revenue forecasting. The Bureau will typically prepare a forecast in late January in the odd-numbered years, and the forecast becomes the basis for the legislative consideration of the budget. The Bureau also tends to prepare another biennial forecast in May as the Joint Committee on Finance is concluding its work. It is interesting to note how much the forecasts can change in just a few months.

In recent months, questions have been raised as to whether the forecast has been changed to meet a political agenda. The revenue forecast issued by the Department of Revenue on November 20, 2002, for the 2003-05 biennium projected revenue growth of 5.8 percent in the first year of the biennium and 5.3 percent in the second. Given the current stubborn, sluggish nature of the economy, these projections seemed overly optimistic to some. Employment is down, the stock market is moving sideways, and the holiday shopping season has been a disappointment.

However, the analysts at the Department of Revenue are remarkably indifferent to what might be considered smart politics. Their forecast was prepared, as it has always been prepared, by running the national model and tailoring it to Wisconsin. The 5.8 percent/5.3 percent forecast was critically challenged by budget analysts from the Department of Administration. In the end the Department of Revenue analysis was used for the November 20 report. To do otherwise would have been to politicize the forecast.

How good is Wisconsin's revenue forecasting ability? Given our propensity to appropriate every dollar that the state collects, this is a significant question, particularly during a down economy. To miss a forecast by even a small

amount means budgets must be recast in mid-year. This was the case last year when the budget fell \$1 billion short of the forecast, and again this year when revenues are projected to fall \$373 million short of the most recent forecast that was prepared nearly a year ago.

Given the data available (and the time horizons involved, and the enormity and diversity of Wisconsin's economy), the forecasts are reasonably credible. However, the forecasts could be improved in three ways. First, Wisconsin would benefit from the insight of a wider range of economists when assembling forecasts. To this end it would be useful to assemble a formal, independent body that is charged with providing input into the official revenue forecast for the state. This would allow state government to draw from the expertise of private economists, university faculty members, the Federal Reserve, and staff from other national forecasting services.

Second, given the complexity and volatility of the state's economy, forecasts should be prepared on a more regular basis. Recent experience with a fragile economy suggests that forecasts be prepared on a quarterly basis.

Finally, the revenue forecasting process should be open to public scrutiny. While there has been no partisan agenda at work in recent forecasts, the perception that the numbers might be fudged does not inspire confidence from the citizenry. For both the Governor and the Legislature to work from one set of numbers prepared in public by the finest minds available would upgrade the budget process considerably. Reviewing and updating the forecast on a quarterly basis would bring to government a significant tool used widely in the private sector.

Looking back on the decade of the 1990s, two salient points are apparent. First, the factors driving state revenue collections were not well understood. What caused the tremendous revenue growth? While there was a general sense that the economy was energized, it was not matched by an understanding of exactly how that strong economy yielded ample state revenue collections. However, when things are going well, there is little incentive to ask why. That sort of thinking has caused the demise of several once-mighty businesses, and it is a key cause for Wisconsin's current deficit.

Second, given the volatility of state revenues, most industries would have recognized the volatility and planned accordingly. State government did take some steps in this direction, but its heart never seemed to be in the planning strategy. For example, a budget reserve fund (Wisconsin's version of a rainy day fund) is provided for by the statutes, but that fund contains only a few dollars of largely symbolic contributions. In the 2001-03 budget, after the economic downturn was in full swing, a statutory requirement was enacted requiring that 50 percent of unanticipated revenue growth be allocated to the budget reserve. While this provision at least holds some potential for funding the budget reserve, it will only occur if revenue growth exceeds projections. Once again, revenue growth is seen as the only way to address a basic fiscal management need. Further, since this is a statutory requirement, it could be changed or repealed if there were a competing demand for whatever funds accrued to the account.

In addition to the budget reserve, the statutes require that each budget include an uncommitted balance. This mechanism is intended to accommodate rather modest variances between revenue forecasts and collections. In the current budget year the requirement is that 1.2 percent of revenues or approximately \$134 million of expected revenues be uncommitted. The uncommitted balance requirement is statutorily scheduled to increase by 0.2 percent annually until it reaches 2.0 percent of revenue in 2005-06. The current proposal from the Governor would reduce the uncommitted balance to \$35 million in 2003-04, \$40 million in 2004-05, and \$75 million in 2005-06. The target date for reaching the goal of a 2.0 percent uncommitted balance would be delayed one year to 2006-07.

Having a small uncommitted balance has been minimally helpful in mitigating the effects of lower revenue collections. The size of the balance can hardly withstand a downturn of any significance. Further, without an adequately funded budget reserve, Wisconsin state government is defenseless in the face of even a mild softening of the economy.

SPENDING INCREASES

Government is not a business. That point is indisputable, both in philosophy and in practice. While state government is the largest enterprise in Wisconsin, it lacks the external fiscal discipline of most businesses. Its fiscal planning horizon is two years. Although the Wisconsin budget balances year in and year out, a balanced budget can belie serious fiscal problems, as is now apparent.

Expenditure Commission: Comment from the Past

Observers from several quarters have attributed the state's fiscal problem to overly high spending. That explanation, while correct, is too simple. It masks the root cause of the problem — namely, that state government's fiscal-planning horizon is too short. Planning within this short horizon is akin to trying to sail the Chicago-to-Mackinac race by always following the bow of the sailboat. Using that technique one can always be assured of moving forward; but, with no plan for the entire race, the technique will never ensure a successful journey. State government has lived from biennium to biennium, balancing each two-year budget along the way. Little attention, if any, has been paid to any long-range fiscal planning, the type that is required of any small business attempting to secure a loan from its local bank.

This problem of short-term fiscal planning was addressed the last time state government faced lagging revenues. The State Expenditure Commission, appointed under Governor Earl in 1986, addressed this need for a longer-term perspective in budgeting. While that commission focused primarily on state spending levels and trends, it also examined the manner in which budgets are constructed in Wisconsin.

Earlier, this study noted the volatility of state revenue collections in the decade of the 1990s. With that in mind, the following statement from the Expenditure Commission report seems eerily prophetic:

Revenue volatility from the business cycle has created confusion regarding the purpose of the budget exercise. Too often, the objective has become simply matching expenditures to revenues in each fiscal period. In such an environment, distortions occur. When government revenues increase, as in the inflationary 1970s, expenditures grow to meet 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 report went on to suggest:

This does not argue for a repeal of the balanced budget. Rather, it argues for longer-term goals and a more deliberative policy regarding the level of government spending.

The Expenditure Commission also looked forward beyond the late 1980s into the 1990s. With a lack of longer-range fiscal planning, what did the commission see as likely for the 1990s?

Although expenditures and revenues were shown to be generally in balance over the ten-year period (1990-2000), no new programs were assumed within the expenditure estimates. ...If major new spending or tax reduction initiatives are undertaken, cutbacks in the current levels of some public services or legislated tax increases are likely to be required.

Through the 1990s Wisconsin government established several new spending initiatives. These occurred across a wide swath of budget categories — corrections, education, social services, and property tax relief — all of which generally had wide support. The new spending initiatives fulfilled the Expenditure Commission's prediction that cutbacks or tax increases would eventually be required.

New spending could only be supported with new revenue. As shown earlier, new revenue was plentiful. With no longer-range planning to constrain spending, few initiatives seemed beyond the reach of state government. In fact, state government became so enamored of being able to take on almost any new initiative that spending increases continued almost unabated even after the state's fiscal downturn became apparent.

Wisconsin's Fiscal Tools: Is the Glass Half Empty or Completely Empty?

State government has the tools to identify and track fiscal illness. They just are not heavily used. Each year, the State Controller issues the Annual Fiscal Report as required in statute, and each year the Legislative Audit Bureau performs an audit of the state's general purpose financial statements. Year after year, these two respected entities, after detailed analysis, opine that the state's finances are in order, at least within the confines of government accounting and state statutes. This annual statement verifies that Wisconsin spending is within available revenues.

For the past 13 years the state has issued a second financial report, one that is not required by statute, but is required by external entities such as agencies that rate Wisconsin's credit-worthiness. This report is the Comprehensive Annual Fiscal Report (CAFR). Without a CAFR, the state would be unable to sell bonds.

While the Annual Fiscal Report is basically a cash-based report, the CAFR documents the fiscal status of state government on an accrual basis. Cash-based reports can conceal deep fiscal flaws. By contrast, the CAFR shows all of the warts and blemishes of the state's fiscal condition. It is prepared using Generally Accepted Accounting Principles (GAAP).

Since the first CAFR was issued, it has been publicly, annually disclosed that state finances are in deficit. Table 4 shows balances at the end of each year, comparing balances as stated under the official Annual Fiscal Report with balances reported under the CAFR. The two reports show a remarkably different picture, one rosy and one troubled. It is little wonder why the rating agencies and others insist on a CAFR report. In July of 2002, while the Annual Fiscal Report showed the state having a \$74.6 million balance, the CAFR showed a \$1.5 billion deficit. In terms of business, if state government were to cease operation, it would fall \$1.5 billion short of meeting its obligations.

Yet, until recently, the CAFR has been relegated to obscurity. Only the bond rating agencies and a handful of fiscal analysts in state government have shown interest in the report. That should change in the future.

Fiscal weakness can also be seen in the need for short-term borrowing. Like any enterprise, state government has a need for short-term borrowing to meet its cash flow needs. State government can borrow up to 8 percent from other funds it manages to supplement the general fund, and it can access public markets for short-term operating notes. Internal and external borrowing both require repayment with interest.

**TABLE 4 COMPARISON OF YEAR END BALANCES
ANNUAL FISCAL REPORT VS. COMPREHENSIVE ANNUAL FISCAL REPORT
FY 1990 – 2002
(\$ IN MILLIONS)**

Fiscal Year	Annual Fiscal Report Ending Balance	CAFR Ending Balance
1990	\$673.3	-\$743.1
1991	507.1	-1,077.9
1992	458.8	-1,167.9
1993	563.0	-1,131.6
1994	681.9	-1,219.7
1995	847.2	-1,128.7
1996	918.6	-918.5
1997	397.2	-1,472.7
1998	589.0	-1,274.4
1999	749.2	-908.7
2000	610.9	-830.3
2001	453.1	-1,214.8
2002	74.6	-1,484.3

Source: State Controller's Office, Wisconsin Department of Administration

Two factors cause the need for short-term borrowing. First, it smooths the difference in revenue and expenditure patterns. In normal years there will be some need for short-term borrowing. However, the need for borrowing is also driven by the level of cash coming into the general fund. When the economy softened in 2000 and into 2001, the need for short-term borrowing grew dramatically. In FY 2001-02, the state came very close to using the maximum of short-term borrowing allowed under law. Nearly \$1.7 billion was needed to ensure all bills could be paid. On a revenue base of \$10 billion, that is a troublesome sign.

The Balanced Budget, Wisconsin Style

The State Constitution requires Wisconsin to balance its budget. This requirement is thought to provide fiscal discipline. We often hear that, because of the balanced-budget requirement, state governments cannot get into the fiscal messes that plague the federal government. But the sense of security implicit in this view is unfounded. The balanced-budget requirement provides only *an illusion of discipline*. Further, it ensures *short-term fiscal planning*.

To elaborate on the above, one need only understand certain techniques used in the past to ensure that budgets would be balanced. On more than one occasion the statutory date when a local aid payment was to be made was shifted by a few weeks. This seemingly harmless change moved the expense of that aid payment from one fiscal year to the next. The FY 2002 CAFR shows that \$492 million in shifts of this sort have been made over the years to help bring budgets into balance.

A more recent example of “non-standard fiscal management” was \$75 million saved from debt restructuring in the 2001-03 budget. The “savings” was attributable to refinancing outstanding bonds and deferring payment on the new bonds for two years. This two-year deferral “saved” the general fund \$75 million that was then available for spending. Actually, all this move did was increase the overall cost of the debt service on the bonds in future years. The CAFR will account for this.

The largest and most controversial budget-balancing maneuver in recent years was the use of proceeds from tobacco securitization. Wisconsin and several other states securitized the payments from tobacco companies that generated significant cash. In the past two years, \$1.3 billion of tobacco securitization revenue have been used to fund the budget. A few observations are in order. First, the use of this extraordinary revenue source was a sign of a deep fiscal problem. Second, the tobacco money in Wisconsin served as a de facto budget reserve. Stated differently, if Wisconsin had had a rainy-day fund, there would have been no need to spend securitized tobacco proceeds. Third, the use of tobacco proceeds is not the cause for the current fiscal imbalance. It only served to delay having to address the fundamental budget imbalance. The many states that spent either tobacco proceeds or rainy-day funds, hoping the economy would recover, are now facing major budget problems.

Wisconsin was hardly alone in using short-term fixes to address its emerging budget shortfall. In a study done for the American Legislative Exchange Council, William D. Eggers notes:

What did most states do in 2002 to address their large budget deficits? One theme clearly stood out: How little can I get away with doing? Everyone raided the rainy-day fund. Many states hiked cigarette taxes; some of the same states plundered the tobacco settlement money. . . . Another popular strategy was rifling through other portions of the budget — education endowments, transportation funds — hunting for stray money to pay down the deficit.⁸

New Programs = New Money

Incremental budgeting is how most governments set their spending plans. Wisconsin is no different. The state budget starts with last year’s spending and builds on it. This is not an approach that encourages evaluating and changing existing programs. While there have been examples of fundamental changes to existing programs — e.g., the W-2 program and school choice — the vast majority of new spending is funded from new revenues.

Some have argued that the state’s fiscal problem stems primarily from the wide range of new programs begun in the 1990s. Undoubtedly the balance sheet would look significantly better without the additional programs. Yet the fundamental issue is not whether government should initiate new spending or tax cuts; it is, rather, how such initiatives are to be funded. To suggest that it is wrong for government to take on new responsibilities is to deny the changing nature of society. Things change, needs differ, and citizens expect government to adapt to changing circumstances in order to do what is expected of government.

That is not to suggest that government should create a new program every time a new need is identified. Were that the chosen approach Wisconsin would begin to resemble Sweden. Instead, it is to suggest that new and changing demands on government should not be solely dependent on new money coming into the system. There should be a capacity to review the effectiveness of existing spending initiatives. Base spending should be in play when new spending initiatives are considered. That rarely happens.

Little real attention is paid to either the effectiveness or the current relevance of existing programs. Ideally, any proposal for a new spending program would be traded off against an existing program. Such discussions almost never occur. Why is that? Because forces to protect existing programs serve as an incredible barrier to change. Among those forces are the following:

- If a legislator is responsible for, or closely identified with, the existing program, that legislator will work vigorously to ensure that the program is unchanged or expanded.
- The executive agency staff responsible for the program will usually be advocates for the program. This is not something to be criticized. People charged with operating a program should believe in the program. But no one should expect that staff to suggest that the program they administer has outlived its usefulness.
- Programs have constituencies that often become active in the political arena to ensure that their interests are preserved.

All this is to suggest that the forces working against base budget review are substantial. Further complicating the task is the fact that government is not given to articulating what the program is intended to accomplish in a quantifiable manner. In the few cases where program metrics have been developed, they have been developed by the program staff, the advocates, or both. Neither group has an interest in a completely objective review of the program.

Measuring program effectiveness has been a mirage sought by government for a long time. Performance measurement is the technique receiving the most attention among the states today. Many states, including Wisconsin, have begun performance measurement efforts. But in a study done for the American Legislative Exchange Council, William D. Eggers states: “With few exceptions, performance budgeting has not worked nearly as well in practice as in theory. One of the main stumbling blocks is a legislative reluctance to incorporate performance information into the budgeting process.”⁹

State agencies in Wisconsin are required to develop performance measurements and include them with their budget requests. This requirement has yielded some interesting information, but it will likely have little impact on the allocation of money in the budget. Wisconsin is like most states in that there is little commitment on the part of policy makers to evaluate programs in the context of budget allocations. It is likely that performance measures will receive little attention after they are forwarded with an agency budget. Performance evaluation has yet to take root in Wisconsin.

Also, the performance measures developed by the agencies are uneven. Some are well conceived and measurable. For example, the Division of Health has developed interesting metrics on youth smoking rates and infant immunizations. Conversely, the Department of Public Instruction has developed only very limited performance measures. That department suggests its performance should be judged on the number of emergency educator licenses issued, the number of hits on its web sites, and minority scholarship students enrolling in post-secondary programs. It would be difficult for the Governor or the Legislature to use those measures to make decisions on funding education in the budget.

What might be worth trying would be to have an objective third party — e.g., the Legislative Audit Bureau — develop performance measures for a dozen or so key programs. The measures must not become bureaucratized, as has been the case in other states, and should focus primarily on those programs receiving significant state funding. Without serious commitment to program performance measurement, Wisconsin will continue incremental budgeting, continuing old programs, adding new programs and hoping revenue materializes to support both.

STATE SPENDING IN THE 1990s

The 1990s was a decade of tremendous growth in state spending in Wisconsin. As Table 5 shows, during the 1990s the state budget grew from \$5.8 billion to \$10.6 billion, an increase of 82 percent. The average annual growth rate was 6.9 percent, while the inflation rate averaged 2.9 percent and the population grew by 0.9 percent. Per capita personal income rose from \$18,152 in 1990 to \$28,471 by 2000, an average annual growth of 4.6 percent.

One way to benchmark the growth in state spending is to look at spending in 1990 and see what it would have been in 2000 if spending just kept pace with inflation and population growth. Had that been the case, spending in FY 2000 would have been \$8.5 billion rather than the actual spending of \$10.5 billion. A calculation has been made on what spending would have been in each year of the decade if it had been increased to reflect only CPI and population increases. Comparing this spending estimate with actual annual revenue collections would have yielded a cumulative savings of \$8.9 billion by the end of the decade. This theoretical savings is in stark contrast to the State Budget Office information showing that state government closed the 1999-01 biennium with a “structural deficit” of \$475 million.¹⁰

Why did expenditures so significantly outstrip inflation and population? One factor was an attempt to reduce the property tax through increased state aid. (In a later section, this study will outline the move to 67% state funding of schools as an attempt to “buy down” property taxes.) In its purest form this simply replaced local revenue with state revenue. This study estimates that this contributed to \$3.6 billion of the \$8.9 billion cumulative total of excess spending. (There are a number of ways to estimate the cost of buying down property taxes. This exercise calculated the difference between the state’s payment of 2/3 of school cost from fiscal year 1996-97 through fiscal year 1999-2000, with the state payment had the state share remained at the pre-1996-97 level of 52.7% of school cost.)

TABLE 5 GPR EXPENDITURES FY 1990 TO FY 2000
ACTUAL EXPENSES, MILLIONS OF DOLLARS

	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98 (ii)	FY99	FY00 (iv)
School Aids (i)	1,619.2	1,843.3	1,942.4	2,025.2	2,161.5	2,450.8	2,685.8	3,527.6	3,662.2	3,859.7	4,173.3
UW System	692.1	734.3	753.5	765.3	808.1	849.8	847.4	853.4	876.8	903.6	953.8
Shared Revenues	808.4	835.6	894.0	911.0	928.7	972.3	1,012.6	1,008.6	1,008.6	1,008.6	1,008.6
Medical Assistance	588.6	659.9	759.3	801.4	834.6	843.3	877.1	865.6	904.8	927.8	971.0
Corrections (iii)	178.6	201.9	225.5	248.5	280.9	337.5	370.7	396.2	459.0	522.6	583.4
Property Tax Credits	319.3	319.3	319.3	319.3	319.3	319.3	319.3	319.3	469.3	469.3	469.3
Community Aids	183.2	199.9	199.8	209.1	193.2	216.5	217.7	206.7	174.6	175.4	182.5
Income Maintenance	161.6	160.7	162.4	157.2	155.0	143.3	124.3	108.7	149.7	134.7	189.7
Tax Relief to Individuals	152.4	162.7	167.4	173.0	179.6	188.7	192.9	177.0	173.9	167.2	133.4
VTAE Aids (v)	88.6	92.5	96.0	99.0	116.6	110.2	110.2	110.2	111.9	130.0	128.7
Other Local Assistance	270.3	319.0	302.1	343.8	371.5	408.9	421.6	437.4	420.8	379.4	443.0
Other Aids to Individuals and Orgs	225.7	258.6	267.8	296.6	304.2	327.2	320.3	332.1	350.0	406.7	428.2
Other State Ops (includes transfers)	515.0	577.4	576.6	572.8	628.0	654.0	669.8	682.9	717.9	760.4	905.8
Total Local Assistance	3,289.0	3,609.6	3,753.6	3,907.4	4,090.8	4,468.1	4,767.2	5,609.8	5,847.4	6,022.4	6,405.4
Total Aids to Individuals	1,128.3	1,241.9	1,356.9	1,428.2	1,473.3	1,488.1	1,514.6	1,483.4	1,578.4	1,636.4	1,722.3
Total State Operations Lapses	1,385.6	1,513.7	1,555.6	1,586.6	1,717.0	1,833.8	1,880.5	1,932.5	2,053.7	2,186.6	2,443.0
Total – Actual	5,803.0	6,365.2	6,666.1	6,922.2	7,281.1	7,790.0	8,162.3	9,025.7	9,479.5	9,845.4	10,570.8
% Increase Over Prior Year - Actual	6.4%	9.7%	4.7%	3.8%	5.2%	7.0%	4.8%	10.6%	5.0%	3.9%	7.4%

(i) School Aids include S.20.255(2) local assistance plus supplemental state school aids. School Aids paid from lottery fund not included.

(ii) FY 98 expenditures exclude \$215 million for Special Investment Performance Dividend (S.I.P.D.) payment.

(iii) Amount for Corrections excludes juvenile corrections expenditure in FY97 and FY98. These are shown in other state operations.

(iv) FY00 expenditure does not include \$700 million in sales tax rebate payments.

(v) Vocational, Technical and Adult Education

State Budget Office, Wisconsin Department of Administration

If one accepts that \$3.6 billion of new state spending was simply a transfer from local to state revenues, there still remains \$5.3 billion of additional state spending beyond what could be explained by inflation and population growth. Why did expenditures grow to that extent? The short answer is because they could. As noted previously, the Expenditure Commission referred to the budget process as an exercise of matching revenues with expenditures. That is precisely what happened throughout the 1990s and what is still the practice of today.

Spending increases in the 1990s occurred in every area of the state budget. Outlined below are some of the more significant examples of spending increases: corrections, medical assistance, education/property tax relief, and state agency operations. A review of these areas demonstrates how the short-term fiscal horizon caused spending to rise dramatically during a period of substantial revenue growth. But, as is now known, that spending was not sustainable.

Corrections

While the overall growth of state spending in the 1990s was substantial, nowhere was that growth more pronounced than in corrections. A review of some key statistics will provide an insight into the magnitude of this growth. During the 1990s, Wisconsin increased its level of spending for corrections by 226 percent. One survey by the National Association of State Budget Officers showed Wisconsin's growth in spending for corrections during the 1990s was two times the growth of any other state.¹¹

During that decade ten new state-operated correctional facilities housing 3,524 beds were brought on line, and three other existing institutions were expanded by 1,838 beds. In total, 5,362 beds were added in the 1990s. (Since 2000, another four institutions with 3,298 beds have been opened, and five more with 1,600 beds are awaiting budget authority to open.) These beds were needed to house the inmate population that rose from 7,117 to 20,447.

In spite of the significant growth in the number of new state facilities, state facility construction couldn't keep pace with swelling prison populations. It therefore became necessary to look elsewhere for available beds. In 1996 Wisconsin began contracting for beds out-of-state, first with counties in Texas, then with the federal government, and ultimately with a private for-profit company (Corrections Corporation of America). In addition, the Department of Corrections contracted with a number of Wisconsin counties for available beds. In January of 2001, just after the close of the decade, Wisconsin was housing 5,000 inmates in non-state facilities.

The 1990s saw a significant increase in the number of inmates supervised under the parole and probation program. The average daily population under probation and parole grew from 35,143 in 1990-91 to 63,403 in 1996-97. Since that time the population has been somewhat stabilized; it stood at 63,997 in 1999-00. Still, that is an increase of 82 percent from the beginning of the decade to the end.

Other studies have examined Wisconsin's approach to corrections in much more depth. For purposes of this study, it is simply the magnitude of the spending on corrections that is significant. The cost of providing corrections for Wisconsin's adult population grew from \$178.4 million in 1990 to \$583.4 million in 2000, an increase of 226 percent.

The decade of the 1990s was marked by widespread concern about crime in America. Wisconsin did not escape the effects of this trend. Surveys performed by the Wisconsin Policy Research Institute show that crime was a significant concern in the state. For most years of the decade, crime was the second-most prominent concern of Wisconsin citizens (trailing only taxes). In a 1994 WPRI survey, crime was the top concern.¹²

Wisconsin wanted to get tough on crime, and it did. The Wisconsin Legislature passed several laws extending sentences for specific crimes, and the budget ultimately provided the wherewithal to pay for the resulting need for prison beds. The relationship between longer sentences and added prison capacity was hardly scientific. (In fact, late in the decade, Representative Krug and Senator Panzer sponsored legislation to require a prison impact statement to accompany each new piece of legislation affecting sentencing.) However, as tougher sentencing laws were enacted, there was a general sense that funding would be available to build and operate the necessary prisons. In short, Wisconsin's adult corrections budget grew to the extent it did because it could.

Education

It is not possible to understand the state budget in Wisconsin without understanding school aids. In 1990, school aids were significant, accounting for 28 percent of the state budget. By the end of the decade school aids had grown to account for 40 percent of the budget. How and why did that growth occur?

As shown in Table 6, during the decade of the 1990s, public school enrollment rose by only 12 percent. Total school costs rose by 82 percent. After adjusting for enrollment growth, the cost per pupil rose 62 percent. By contrast, state aid rose by 150 percent during the 1990s. Clearly something other than inflation and enrollments was driving state spending.

Discussions of education finance focused on two primary concerns, the school property tax levy and the fairness of the school aid formula. (This latter concern resulted in court challenges of the aid distribution formula and suggestions that other distribution mechanisms would be "fairer.") The impact of schools on the property tax dominated the discussion of education finance, and for good reason. In the four years from 1990 to 1993, school spending rose by an average of 8.5 percent annually.¹³ At the same time the consumer price index was increasing at an aver-

TABLE 6 STATE SCHOOL AID, GROSS SCHOOL LEVY, TOTAL SCHOOL COSTS, ENROLLMENTS AND INFLATION (1990-1991 THROUGH 1999-2000) (\$ IN MILLIONS)

Fiscal Year	State School Aid		Gross School Levy		Total School Costs		Public School Enrollment(b)		Costs Per Pupil	
	Amount (a)	Percent Change	Amount (a)	Percent Change	Amount (a)	Percent Change	Pupils	Percent Change	Amount	Percent Change
1990-91	1,857.4	9.7%	\$2,356.4	9.2%	\$4,555.7	10.0%	797,621	1.9%	\$5,712	8.0%
1991-92	1,950.4	5.0	2,568.0	9.0	4,877.1	7.1	814,671	2.1	5,987	4.8
1993-94	2,046.0	4.9	2,843.8	10.7	5,287.9	8.4	829,415	1.8	6,375	6.5
1992-93	2,186.6	6.9	2,988.1	5.1	5,527.1	4.5	844,001	1.8	6,549	2.7
1994-95	2,462.0	12.6	2,995.7	0.3	5,848.2	5.8	860,581	2.0	6,796	3.8
1995-96	2,705.2	9.9	3,023.6	0.9	6,150.2	5.2	870,175	1.1	7,068	4.0
1996-97	3,566.1	31.8	2,528.1	-16.4	6,546.8	6.4	879,149	1.0	7,447	5.4
1997-98	3,804.7	6.7	2,590.4	2.5	6,939.0	6.0	881,248	0.2	7,874	5.7
1998-99	3,989.4	4.9	2,735.8	5.6	7,250.7	4.5	879,537	-0.2	8,244	4.7
1999-00	4,226.3	5.9	2,795.2	2.2	7,535.3	3.9	877,713	-0.2	8,585	4.1

(a) In millions of dollars; 1996-97 through 2001-02 state school aids are appropriated amounts.

(b) Headcount of the number of pupils enrolled on the third Friday in September.

Source: Wisconsin Legislative Fiscal Bureau

age rate of 4.1 percent annually. This remarkable growth in spending not only placed enormous pressure on the school aid budget, it placed even more pressure on the local levy. During that four-year period local levies rose by an average of 9.3 percent annually. There should be little wonder why there was pervasive concern with the property-tax impact of the schools.

State government took several steps to address rising school levies. First, the 1993-95 budget included school spending limits. Spending was limited basically to inflation, with some exception made for enrollment growth and additional spending approved via local referenda. Second, additional state aid was added during that same budget.

Throughout much of the time the 1993-95 budget was being debated by the Legislature, it looked doubtful that significant state aid increases would be possible. Then, late in the budget process, a revised revenue forecast was issued. Specifically, an additional \$208 million was projected to come to the state in the coming biennium. The *Wisconsin State Journal* reported on May 14, 1993, "earlier this week new revenue estimates from the LFB (Legislative Fiscal Bureau) and DOR (Department of Revenue) showed \$208 million more will be available to spend in 1993-95 than previously estimated. The administration immediately signaled a lot of the money would go for building up the state aid pots that had shown little growth in the 1993-94 fiscal year."¹⁴ Once again revenue growth came to the rescue.

As noted, in education, property tax relief was a priority. And the combination of cost controls and significant state aid increases stopped property tax increases almost dead in their tracks. While the school property tax levy rose by 10.7 percent in 1992-93, the three subsequent years saw the rate of increase drop to 5.1 percent, 0.3 percent and 0.9 percent.

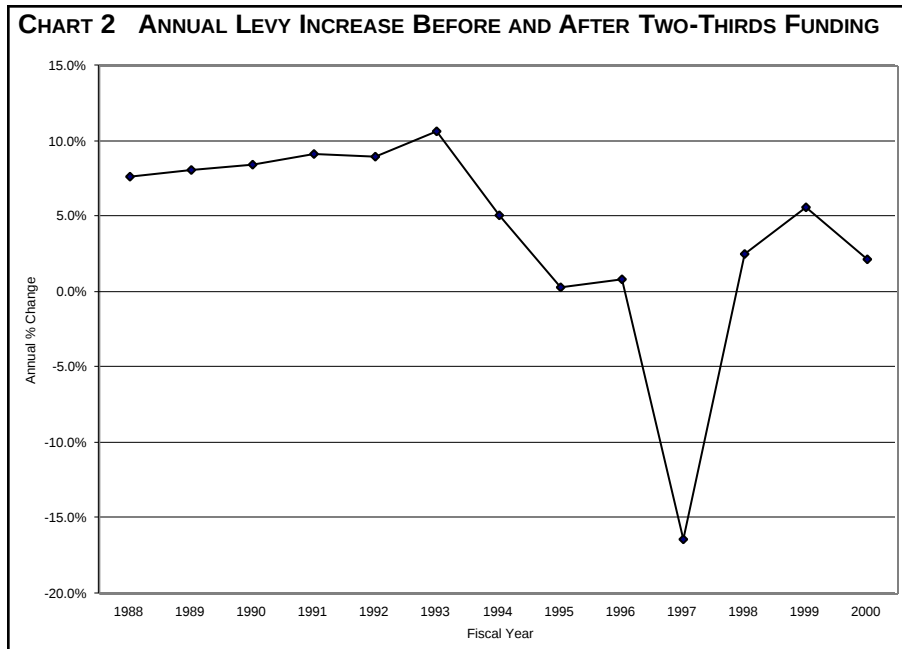
All effort focused on slaying the property-tax dragon. As articulated by the Wisconsin Taxpayer's Alliance, the aggressive funding of property tax relief "is the biggest thing to happen in state government in 30 years."¹⁵ But there was an even larger shoe yet to drop. Could the state actually make the local levy go down?

As we now know, the answer was yes. In 1993, Act 437 was signed into law by the Governor, making a commitment to appropriate adequate state funds by 1996-97 to cover 66.7 percent (later changed to 2/3) of the cost of the K-12 schools. That was a remarkably lofty goal, but it was indicative of the heady times of the mid-1990s. When the

commitment was embodied in Act 437, state aids were covering only 48.3 percent of school costs. To reach that goal would require an *increase* of \$1 billion between 1995-96 and 1996-97. And that is exactly what was done. School aid was increased by \$861 million, and the school levy credit was increased by \$150 million.

The almost inconceivable had been accomplished: local property taxes went down. Overall, the school property tax levy shrunk 16.4 percent in 1996-97 alone. And it was accomplished without increasing state taxes. As Governor Thompson noted, “The 1995 budget, funding state government over a two-year period, represented the first time in state history that property taxes were cut without increasing other tax rates.”¹⁶ It is really quite breathtaking in retrospect; it was even more so at the time.

Only minor modifications have been made in school finance since then. In 1996-97 today’s ground rules for state education finances were put in place. Much has been written about the wisdom of that policy, but it is incontrovertible that the goal of minimizing property tax increases seems to have been met. Chart 2 shows the impact of cost controls in



1993, the state aid increase of 1997, and the subsequent period of keeping up with the 2/3 funding commitment.

School aid is a significant contributor to the current budget problem, if for no other reason than its size. For purposes of this study, it is also an example of how the problem was created. At the root of the school finance issue is the almost mythical notion that school property tax levies could be controlled, much less reduced. That very popular public policy goal was met, and it was met within a series of balanced budgets.

Yet, recasting school finance was not undertaken in the context of longer-term goals for state finances. Nor was the sustainability of the initiative assured. Just the opposite. Observers of state government wondered about the sustainability issue. The Wisconsin Taxpayers Alliance wrote, “The major financial challenge is of unusual origin. It is not a drop in revenues or a surge in spending — it is caused by a concern regarding the property tax burden. It is widely understood that the next budget (1995-97) is underfunded.”¹⁷ Imagine if the Taxpayers Alliance had looked out further than that next biennium.

While property tax relief dominated education budgets in the 1990s, Wisconsin state government found the wherewithal to establish two significant new spending programs targeted at emerging needs in education. The SAGE (Student Achievement Guarantee in Education) program and the TEACH (Technology for Educational Achievement) program represent major new spending initiatives aimed at spending more state money to address specific education goals.

SAGE

Public education in America has traditionally been marked by concern over class size. Wisconsin is no different. In 1994 the Department of Public Instruction published the “Urban Initiative Study” recommending lower class sizes for low-income students, particularly in the early grades. With that study as background, the Legislature included a rather modest initiative in the 1995-97 biennial budget.

Under the original SAGE (Student Achievement Guarantee in Education) program, any district having a school with an enrollment of at least 50 percent low-income students could participate in the SAGE program. The program was aimed at the youngest learners, targeting students in kindergarten and first grade only. Schools opting into the program received \$2,000 for each kindergarten and first-grade student in the program. In return the school signed a

five-year agreement, committing to reducing class sizes to 15 students, extending the hours the school would be open for community activities, and beefing up the curriculum. The Legislature also required the Department of Public Instruction to arrange for an evaluation of the program.

The SAGE program originally went into effect in 1996-97 with 30 schools participating. The cost of the program was \$4.3 million. Since that rather modest beginning, SAGE program growth has been tremendous. Since then the Legislature has expanded the program to make all school districts eligible for funding, and it has added grades two and three. Significantly, poverty is no longer a requirement for participation in the SAGE program. So the original focus has been blurred; not surprisingly, the costs have grown tremendously.

That \$4.3 million program has now grown to \$95 million in the 2002-03 budget. Further, it is anticipated that the program will be oversubscribed, thus requiring rationing of the \$95 million.

The SAGE program is instructive in understanding Wisconsin's growth in spending and the difficulty in lowering spending in the future. Whether or not one agrees with the findings, the evaluation of the program suggests that it has been somewhat effective in raising the educational achievement of low-income students in the earliest years of school (especially African American first-graders).¹⁸

The SAGE program is exemplary of budgeting in the 1990s. When the program was initiated, there was no consideration given to funding the new initiative from reductions to other programs. There was an incomplete understanding at best as to the eventual cost of the program. This was also true when the program was twice expanded later in the decade. And, like all of the other major growth categories in the budget, the tremendous growth was managed within the balanced budget requirement. Yet here is a relatively new program that is contributing nearly \$200 million to the current \$3.2 billion budget problem.

In considering the need to reduce overall spending in the budget, what is the likelihood that this program, which provides for all school districts to reduce class sizes, would be reduced or eliminated? Those chances are not high. In a relatively short time this modest initiative has grown in importance to many school districts. Like so many programs, the SAGE program has taken on a life of its own.

TEACH

In at least two ways, the age of the computer has had a profound effect on education: students need training in the new technology and the Internet has yielded new education-delivery methods. TEACH is a comprehensive program that placed Wisconsin among the most aggressive states in bringing technology into the classroom.

The TEACH program has many components including \$35 million per year for block grants to all school districts for general technology purposes and \$4 million per year to train teachers in the use of technology. Both of these components are funded from general purpose revenues. In addition, the program provides funding for school districts to purchase telecommunication access. Finally, the initiative includes half-price wiring loans, to provide electrical and telecommunication wiring in schools. This permits students in older buildings the same access to the Internet that other students have. The school district repays half of the loan and the state repays the other half.

Overall, the TEACH program represents a major initiative undertaken at a time when state revenue growth was substantial. When the program was designed, little attention was paid to the possibility of funding this program by reducing or eliminating other programs. Little consideration was given to whether TEACH was a program which would could be funded in the future. Rather, the drive to meet a significant emerging need was predominant.

The TEACH program has not experienced the growth of the SAGE program. Yet it does share a commonality with SAGE; both are popular spending programs that are embedded in school district budgets throughout Wisconsin. In the budget now before the Legislature, the Governor has proposed eliminating the state funding for TEACH. It will be interesting to see if that proposal stays in the budget.

Medical Assistance

It is generally assumed that the requirement to fund two-thirds of school costs is the most significant burden on the Wisconsin budget. However, in the 2003-05 biennium Medical Assistance (MA) will require significantly more state funding to meet ongoing needs than school aids will require. Specifically, the estimated state cost of MA will rise by \$663 million in the coming biennium, compared to \$446 million required for school aids.¹⁹ MA cost increases are driven by increases in caseloads and increases in medical costs.

In its history and the spending pressures it exerts, MA differs from the other budget drivers outlined above. First, what is MA? MA is a federal umbrella program under which medical and related services are provided to elderly, disabled, and low-income individuals and families. Included in MA are programs to provide long-term care, community placement for people who would otherwise be institutionalized, health care for families who have qualified for Aid to Families with Dependent Children (AFDC), hospital care, physician services, prescription drugs, and other, similar services. Suffice it to say that MA is a complex series of programs, each subject to myriad eligibility and operational rules.

While MA is a federal program, each state is allowed fairly wide discretion in how the programs are operated. Wisconsin has one of the more comprehensive MA programs and is recognized as having one of the most innovative approaches to social services in general. Currently, 563,000 citizens are enrolled in MA programs,²⁰ representing over 10 percent of the state's population.

MA currently consumes \$1.1 billion of the state's general fund budget (\$1.3 billion when segregated funds are included). To that is added \$2.6 billion of largely federal funds for a total MA budget of \$3.7 billion.

Table 7 shows a roller-coaster history of the MA program. In the first two years of the 1990s MA costs rose by 12.1 percent and 15.5 percent respectively. This substantial growth moderated in the mid-1990s and began to rise more rapidly toward the end of the decade. For fiscal years 2000-01 and 2001-02, cost increases have been more substantial, especially in 2001-02 when state costs rose 26 percent in a single year. That upsurge reflected a substantial growth in caseloads due to a sagging economy, while at the same time health care costs were escalating, especially costs for prescription drugs.

**TABLE 7 MEDICAL ASSISTANCE AND BADGERCARE EXPENSES
GPR AND SEGREGATE FUNDS
FY 1990-91 TO FY 2001-02 — (\$ IN MILLIONS)**

Fiscal Year	Amount	% Change from Previous Year
1990-91	\$659.9	12.1%
1991-92	759.2	15.1%
1992-93	801.3	5.5%
1993-94	834.7	4.2%
1994-95	843.3	1.0%
1995-96	877.1	4.0%
1996-97	865.6	-1.3%
1997-98	904.8	4.5%
1998-99	927.9	2.5%
1999-00	992.9	7.0%
2000-01	1,051.7	5.9%
2001-02	1,325.1	26.0%

Source: Legislative Fiscal Bureau

The early years of the 1990s were marked by rising MA populations and rapidly rising health care costs, both of which contributed to double-digit cost increases. This gave rise to a concerted effort to bring costs back into line. Many steps were taken to control MA costs, including the expanded use of HMOs in providing medical care, limits on authorized nursing home beds (this is less significant today, given that occupancy tends to be below 90 percent), restrictions on the number of doctor visits, prior authorization, modest co-payment requirements, and the coordination of benefits. Many other cost-containment steps were taken by the state and by the federal government. These actions, coupled with a growing economy, had the effect of significantly slowing the growth of MA costs in the 1990s.

However, one of the most important factors in reducing MA costs was Wisconsin's welfare reform program. In 1995-96 there were 253,000 people

enrolled in the AFDC program. When the W-2 welfare reform program went into effect in the following year, 1996-97, the caseload dropped to 209,000; it continued to drop, reaching 146,000 in 2000-01. The combination of welfare reform and a low unemployment rate meant lower AFDC caseloads.

At the end of the 1990s and into the current decade, the picture was once again reversed. Cost-containment was replaced with substantial cost increases. As Table 7 shows, cost increases were 7 percent in 1999-2000, 5.9 percent in 2000-01, and a massive 26 percent in 2001-02. A number of factors contributed to the increase, not the least of which was a slumping economy and increased unemployment. In the first two years of the decade nearly 30,000 people were added to the MA-Family rolls.

MA costs were also affected by the creation of three new state programs: BadgerCare, Family Care, and SeniorCare.

In 1999, Wisconsin began BadgerCare, a program to provide health insurance for the working poor. It is unique nationally in that it includes coverage for adults as well as children. In its first year, 45,906 people were enrolled in BadgerCare. By November 2002, enrollment increased to 103,133, an increase of 124 percent in just two and one half years. Considering the state's economic slump, BadgerCare was well timed. It provided a safety net for the working poor, just as predicted. However, it added yet another burden to the state budget. BadgerCare will consume \$61.1 million of state funds in 2002-03.

Family Care is a long-term care program to provide counseling and assessment services and to provide a range of services to individuals in need of long-term care. The intent of the program is to provide support services with a focus on allowing people to remain in the least restrictive setting, including their homes. To date, only five counties have been approved for full Family Care participation. Funding limitations are prohibiting the state from allowing other counties to enter the program. In 2002-03, state-funded Family Care costs are \$71.9 million. Given that 67 more counties have yet to fully participate in the program, and given the state's aging population, this program has enormous growth potential.

The third of these new programs is SeniorCare. This program was created as part of the 2001-03 budget, in response to a widespread concern regarding the impact of rising drug costs on lower-income seniors. The most generous of its kind nationally, SeniorCare offsets some of the costs of prescription drugs for eligible seniors. Originally projected to cost \$78 million per year, its cost is now estimated by the Department of Health and Family Services at \$174 million for the first year of the next biennium and \$215 million for the second year.²¹ Fortunately, in the time since its original approval, the Department of Health and Family services has secured a federal waiver for the program. Approximately 50 percent of the cost of SeniorCare will now be borne by the federal government.

SeniorCare is a groundbreaking program put in place at a time when the significance of the state's revenue decline was coming to be fully understood. Paying for this popular idea was a major challenge. To keep the short-term costs within available revenues, the start-up date was delayed until September 2002. When the program was authorized, there was no realistic estimate of its long-run cost or how it would be funded beyond the current biennium. In fact, current cost estimates are significantly higher than original projections. This does not seem surprising, since SeniorCare costs are driven largely by the aging population and the cost of prescription drugs — two automatic "uppers" in the future. SeniorCare thus represents very clearly the potential for short-term budgeting to contribute to long-term fiscal problems.

Also worth noting is how the authorizing language for SeniorCare anticipated dealing with the possibility that funding would be inadequate. The language directs the Department of Health and Family Services to continue to take applications for SeniorCare assistance and to cut off benefits when the funding is exhausted. Fortunately for those receiving benefits, this provision will not have to be invoked this year. However, the mere existence of this provision demonstrates how the state's fiscal problems can affect individuals. From the very outset, some people knew that SeniorCare benefits might have to be terminated within months of the program's initiation. It is a reasonable and serious public policy question to ask whether it is appropriate for a state government to launch a program — one that is vitally important to many seniors — under such tenuous circumstances.

The Medical Assistance programs represent a unique challenge to the state budget. Not only does MA represent one of the largest spending categories in the budget, the benefits directly affect the lives of the most vulnerable ten percent of the state's population. Yet, given the tenuous nature of the state budget, there is little certainty related to future MA funding. With the current short-term approach to budgeting, MA is beset by uncertainty now and likely to face uncertainty well into the future.

MA is a program driven by many factors beyond the control of state government, including the state of the economy, medical and drug pricing, federal funding, and general demographics. Further, demand for MA programs will be highest when state revenues are most stressed. In order to provide any assurance to those who depend on MA for support, it is imperative that longer-range fiscal planning be done for the state budget as a whole. A level of service that is affordable over a sustained period of time, including times when the economy is sluggish, must be defined. This would assist in determining what MA programs could be provided over the long term. It might also reveal that the current level of MA offerings cannot be expanded without a reorientation of base-level spending.

State Agency Operations

Twenty percent of the GPR budget was devoted to government operations in 2000. This category includes the cost of operating state agencies and the University of Wisconsin system. During the 1990s state government operations as a budget category grew significantly. Table 8 shows that general fund spending on state agency operations grew from \$1.3 billion to \$2.2 billion, an increase of \$885 million or 68% (this includes personnel and related costs resulting from the state taking on district attorneys and Milwaukee child welfare).

**TABLE 8 GPR FUNDED STATE OPERATIONS
FY 1991 TO FY 2000
(\$ IN MILLIONS)**

Fiscal Year	Spending
1990-91	\$1,346.2
1991-92	1,448.9
1992-93	1,478.9
1993-94	1,583.6
1994-95	1,633.1
1995-96	1,763.5
1996-97	1,754.0
1997-98	2,135.1
1998-99	2,020.0
1999-00	2,239.3

Source: Wisconsin State Budget Office,
Department of Administration

Of the \$885 million in growth, \$404 million was attributable to the Department of Corrections. (The growth of the corrections budget is documented above.) The balance of agency operations growth is related to the UW System (37.8 percent growth) and all other state agencies funded from the general fund (51.4 percent growth). Clearly, the UW System has become less reliant on state funds to fund growth. Most of the System's growth has been funded from other sources such as gifts, grants, tuition, and other fee revenues.

Looking within the overall state agency growth numbers, it is notable that salary costs grew from \$792 million in 1990 to \$1.2 billion in 2000, an increase of 43 percent. This includes growth from salary increases as well as growth related to the 3,750 employees added in the decade. While salary costs increased 43 percent, fringe benefit costs rose a more substantial 76 percent, mostly due to rising health insurance costs. Health insurance costs paid from the general fund more than doubled in the 1990s. In 1990 the state general fund was paying \$5.6 million each month for employee health insurance. By 2000 that cost had grown to \$11.7 million per month.

Under current statutes, employees participate in the cost of health-care premiums under limited conditions (primarily if the HMO they select has costs exceeding the low-cost HMO in their county by 5 percent or more). In 2002-03, state-funded health-care premiums are \$576 million. Employees pay an additional \$14.5 million of their premium cost.

It is notable that few efforts have been made to control the cost of health care for state employees. Health-care cost increases have generally been accepted as part of the overall compensation package. One exception is Governor Thompson's health-care reform legislation introduced in 1993. This comprehensive bill was based on using the purchasing power of public employees to leverage health-care cost containment throughout Wisconsin. This initiative was not approved by the Legislature.

It is likely that there will continue to be concern regarding the level of spending related to operating state agencies. If that cost is to be reduced, it will be necessary to address the cost of corrections and the cost of employee health care. These are the two most significant factors driving up the cost of state agency budgets (as distinct from program budgets).

THE FUTURE: BETTER, WORSE, OR MORE OF THE SAME?

While the \$3.2 billion deficit has been several years in the making, there is a sense that this is a problem that can be solved once, and that state government then can move forward. After this painful budget is balanced, the theory goes, state government can grow its way back to prosperity.

That theory is wrong. The causes of the state's current fiscal dilemma are deep-seated and structural. Demands for new spending will continue to arise. Revenues will continue to be unpredictable and volatile. If nothing changes, feast-or-famine budgeting will continue.

To demonstrate that a solution might be temporary, I have attempted to project state expenses in the 2005-07 and 2007-09 biennia. Making such a projection is admittedly dicey, since several variables affect the numbers. This is a problem similar to the one facing Andrew Reschovsky in his attempt to estimate a “current services budget” for Wisconsin.²² Like Professor Reschovsky, I also rely on somewhat conservative estimates of spending. My estimates project no significant increase in school spending, no substantial expansion of the prison population (which might be expected under truth-in-sentencing requirements), and no large increases in MA costs. To the extent possible, they are based on recent trends in spending, a reasonable approach given that few changes have yet to be suggested to affect the key cost-drivers. The assumptions are outlined below.

K-12 school aids

It is assumed that enrollment will be stable and that school spending increases will approximate the average of the most recent five years for which data are available. This yields an annual spending increase of 4.9 percent. I have added 1 percent to this growth rate in anticipation of moves to loosen school cost controls. Applying this assumption about school spending to the Governor’s proposed school-aid budget, the state share would be lowered from 66.67 percent this year to approximately 60 percent in 2004-05. This projection assumes that the state share would be lowered by one percent each year in the 2005-07 and 2007-09 biennia. Over the four years of this projection, this assumption would require \$3.5 billion less than if the current two-thirds requirement remained in place.

Department of Corrections

The projection of correction costs is based on information included in the six-year plan prepared by the Department of Corrections as part of the capital budget. In that exercise the Department projects an increase of 2.53 percent in prison population for the foreseeable future. Department costs are estimated to grow at this same rate. (This is almost identical to the projected rate of inflation.²³) This projection might be overly conservative, since no growth is included related to future costs related to truth-in-sentencing.

Medical Assistance

The MA projection is based largely on a review of spending over the most recent five years for which data are available. That period, from 1996-97 to 2001-02, includes both good and bad times for Wisconsin’s economy, a key factor in MA spending. The average spending increase during that period was 2 percent above inflation. This projection assumes the same real increase in spending for the 2005-07 and 2007-09 biennia. It also assumes that current state funding will be not be supplanted with federal funds or other state funds during the four years being examined. Further, it assumes that all but \$100 million per year of non-state funds will continue in the two biennia being projected.

University of Wisconsin System

It is assumed that the budget for the UWSystem will grow at the projected rate of inflation, 2.5 percent annually.

Shared Revenue

It is assumed that shared revenue will be restored to a base funding of \$1.019 billion. Based on the Governor’s budget, this will require the addition of \$270 million in 2005-06. Beyond that it is projected that shared revenue increases would be limited to 2.5 percent annually.

State Agency Operations

The projected cost of state agency operations is based on the GPR funded state operations in the Governor’s 2004-05 budget proposal increased by 2.5 percent annually, the projected rate of inflation. Also, the cost of debt service is increased by 3.32 percent annually, which is the rate of increase in debt service between 1998 and 2002.

All Other Programs

The rest of the state budget is projected to grow by 2.5 percent annually (projected CPI growth) beyond what is included in the Governor’s 2003-05 biennial budget.

Revenue Projection

The State Budget Office estimates that state government should expect a 4.6 percent annual increase in tax revenues during the 2005-07 biennium, based on the ten-year average of revenue growth. That rate is used here for the entire 2005-09 period. Also, the projection uses the level of departmental and tribal gaming revenues included in the Governor’s budget.

Table 9 shows the relation between spending and revenues. It shows that it is possible for state government to face another deficit in the 2005-07 biennium, with a barely balanced budget the following biennium. However, this projection yields an overall spending growth of approximately 3.5 percent. As noted, this is a relatively conservative assumption. It assumes that no new programs will come on line. If history repeats itself, this is highly unlikely. It also assumes a relatively stable demand for MA spending, which will not be the case if there is a downturn in the economy and employment. It assumes a negligible impact on corrections spending related to truth-in-sentencing. It assumes modest increases in school spending in spite of growing interest in removing revenue caps and eliminating the QEO. It assumes that the UWSystem, which is widely recognized as the engine of future economic development in Wisconsin, will receive only limited funding increases. Other sources of pressure for additional spending could easily be added to the list. If any of the conservative assumptions proves to be wrong, the budget will be unbalanced throughout the period. And if all assumptions prove to be too conservative, the imbalance will be significant. Suffice it to say that future Wisconsin budgets will be just as dependent on unusually large revenue growth as has been the case for past budgets.

**TABLE 9 PROJECTION OF STATE SPENDING AND REVENUE COLLECTIONS
2005 – 2009
(\$ IN MILLIONS)**

	2005-06	2006-07	2007-08	2008-09
School Aids/Levy Credit	\$5,588	\$5,822	\$6,063	\$6,313
UW System	943	967	990	1,015
MA/BadgerCare	1,664	1,730	1,817	1,898
Corrections	754	773	792	813
Shared Revenue	1,019	1,044	1,070	1,097
All Other Spending	2,482	2,546	2,608	2,673
Total Spending	\$12,450	\$12,882	\$13,340	\$13,809
Total Revenues	\$12,189	\$12,735	\$13,306	\$13,903
Revenue Balance or (Shortfall)	(\$261)	(\$147)	(\$17)	\$94

Next, the projection has been adjusted assuming a higher-spending scenario and, alternatively, a higher revenue scenario. For the higher-spending scenario the following adjustments have been made to the base case outlined above:

- School spending is held to a 4.96 percent annual increase, but state funding continues to cover two-thirds of the cost.
- State funds would have to back-fill \$200 million of segregated Medical Assistance funding each year, rather than the \$100 million included in the base case.
- Correctional costs would increase 1 percent over the 2.53 percent included in the base case. (This anticipates slightly increased spending for opening currently mothballed prisons and a higher prison population due to truth-in-sentencing requirements.
- UW system spending would increase by 0.5 percent above inflation.
- All other state spending would increase 3.5 percent annually, 1 percent above inflation.

The higher-revenue scenario assumes that state tax revenue increases at a rate of 5.5 percent annually. This is the average revenue forecast used prior to the economic slowdown. This is based on revenue collections over a relatively prosperous period.

Table 10 shows whether there is a surplus or a deficit projected for in the next two biennia under the higher-revenue and spending scenarios. For example, if spending is higher, there will be an expected deficit in the 2005-07 biennium of either \$1.9 billion or \$1.6 billion, depending on revenue growth.

Similarly, a higher revenue scenario would yield a deficit of either \$92 million or \$1.6 billion in the 2005-07 biennium, depending on spending assumptions used. The results for the 2007-09 biennium range from a having a surplus of \$864 million if spending is restrained, to having a deficit of \$1.1 billion if spending is not restrained.

This exercise shows how difficult it will be for state government to grow its way out of the current deficit. Higher revenues will result in a healthy balance sheet only if the gain in revenue is accompanied by restrained spending. If revenues grow at a higher rate than expected, and spending is not restrained, the state will continue to face biennial budget deficits ranging from \$1.1 billion to \$1.6 billion. Unfortunately, history suggests that this is more likely than the restrained-spending scenario.

Will spending be restrained? Time will tell, but the early signs are mixed. The current 2003-05 biennial budget proposal before the Legislature includes significant reductions to agency operating budgets. However, it is less certain that the factors that drive spending for other major programs will be fundamentally changed in the coming biennium. School spending decisions remain in the hands of local school boards operating within revenue caps. MACost-drivers, with the exception of some co-pay and deductible requirements, remain intact. In fact, the FamilyCare program is expanded a bit. Savings in the corrections budget may be achieved through enhanced reliance on community placements, yet that relationship is unproven. Shared Revenue expenses, while reduced by 7 percent in 2004-05, are expected to rise in the next biennium.

In summary, it is not clear that fundamental change will be made to the major spending-drivers in the coming few months while the biennial budget is being assembled. Nor should it be expected that the changes needed to eliminate Wisconsin's feast-or-famine budgeting will be undertaken in the frenetic atmosphere of the legislative budget process.

However, this is just the first step in a two-step process needed to cure Wisconsin's fiscal ills. The second step entails making fundamental changes to the way budgets are constructed, so that we may avoid repeating the current budget horrors in the future. Before detailing those changes, it is instructive to outline the lessons learned from past budgets.

**TABLE 10 SURPLUS/(DEFICIT) GENERATED FROM ALTERNATIVE HIGH REVENUES AND SPENDING
2005-07 AND 2007-09 BIENNIA
(\$ IN MILLIONS)**

Base Case Spending	Base Case Revenue	Higher Revenue
2005-07 biennium	(\$408)	(\$92)
2007-09 biennium	77	864
Higher Spending		
2005-07 biennium	(\$1,913)	(\$1,597)
2007-09 biennium	(1,933)	(1,129)

LESSONS LEARNED

This paper identifies a series of lessons from the past that will assist in rectifying the situation in the future.

Revenues are volatile.

A review of state revenues in the 1990s showed a great volatility in revenue collections. State government is very dependent on revenue from the personal income tax which grew by as little as 1.9 percent in one year and as much as 15.5 percent in another year during the decade of the 1990s. This type of volatility should be expected in the future.

Expenditures are more predictable than revenues.

Particularly in the major spending categories in the state budget, spending trends are more predictable, and, as shown in this study, almost always in the upward direction. State government spending grew by an average of 6.2 percent per year during the 1990s, far outstripping the rate of inflation. This is largely because factors affecting state programs — e.g., population, costs, the economy — tend only to push up, never down. It is also a reflection of the propensity to create new spending programs, even when revenues are lagging.

The balanced budget requirement does not provide adequate discipline in budgeting.

While Wisconsin's constitution requires a balanced budget, this provision has done little to inject discipline into the budget process. Wisconsin's structural deficits demonstrate that revenues and expenditures are not really balanced. This study has shown that lawmakers use revenue growth, one-time financing, payment shifts, and debt financing to create the appearance of balanced budgets. In fact, the balanced budget requirement actually encourages a shorter-term approach to state fiscal management.

Short-term budgeting is fatal.

Each biennial budget is an exercise of matching revenues and expenditures, with little attention given to the long-range implications of short-term decisions. It is easy enough to say that state government should have been salting away some revenue during the good times, but the harder question is how much government can Wisconsin afford? The balanced budget requirement would suggest that we can afford however much revenue is generated. Under this approach we should expect a never-ending series of spending binges followed by severe constriction, not unlike what is facing state government today.

It is not possible to grow out of this problem with new revenue.

A projection of revenue and expenses showed that, using even very conservative estimates of future spending, it is likely that current spending needs will again outstrip future revenues. The state budget will again be in deficit before the close of the decade. Further, that projection assumed that no new state programs would be undertaken — an unlikely scenario.

Also, a lesson from the past is that our budget culture requires that all new revenue be spent, either on expanded programs or tax cuts. Commitments for new spending and tax cuts are already piling up. For example, businesses feel they have a commitment for lower taxes related to changing to a single sales factor for calculating future tax liabilities. Similarly, mayors and teachers are hopeful that state aid will keep up with their future needs. State government cannot grow out of a problem that cannot be measured. Without a plan, who is to say how much growth is needed? Without a plan, any respite provided by revenue growth is likely to be temporary.

Including policy and pork in budgets is troublesome but not fatal.

In an ideal world the state budget would be similar to a corporate budget, exclusively a fiscal document. However, budgets tend to include policy items that have no fiscal effect and local spending items that are intended to ingratiate a particular legislator with the local electorate. Both developments have been criticized in many circles. But if these were the only flaws in Wisconsin's budget system, the current budget problem would be manageable. Pork items in the budget tend to be relatively small spending initiatives, often of a one-time nature. And policy items, while arguably not belonging in a budget bill, have contributed little to the current fiscal problem. More significant than either of these are the spending items that are directed at a wide spectrum of the population, proposed and adopted without consideration of long-range implications. Further, any effort to focus reform on pork and policy will divert attention away from more fundamental changes that could lead to financial stability.

The budget process in Wisconsin is slow to change.

The myriad factors affecting our lives are constantly changing. Yet the budget process is slow to change. A legislator from the 1970s would find many of today's issues foreign, but the process to develop a budget would seem familiar. The familiarity and predictability of the budget process are important to the executive and the legislative branches. This means that any fundamental change in the process, while essential, will be extremely difficult to attain.

New initiatives are almost always funded from new revenue.

This paper has outlined some of the key factors leading to budget increases in some of the major spending programs. There will always be an upward pressure in spending for existing programs. Even shared revenues, which have been flat since the mid-1990s, have seen a push for additional funding from local officials. This means that the only way for state government to meet emerging needs is through revenue growth. Combining the growth needs of new initiatives with the growth needs of existing programs is not sustainable.

Wisconsin budgeting has no tools to assist in base reductions.

Suppose a legislator wanted to pursue a new spending program by reducing an existing program. She would face resistance from a wide variety of sources. It just isn't done. While business has the bottom line to assist in deciding when to scale back or eliminate a program, government has no equivalent benchmark. Attempts have been made over

the years to provide such objective measures, but none have been particularly helpful in the budget process. Zero-based budgeting and performance measures are two attempts to assist in the evaluation of existing programs. Yet these techniques have not had a wide audience and have not had a lasting impact on Wisconsin budgeting.

The needs and wishes of the public lead to new program spending. This paper has documented several new programs begun in the 1990s. New programs often have modest beginnings but mushroom into significant spending programs. It might be hard to fathom in the current fiscal environment, but it is almost certain that government will continue to create new spending initiatives. The challenge becomes: How can this be accomplished in a manner that will not create a future budget shortfall?

CHANGES TO PREVENT FEAST-OR-FAMINE BUDGETING

The state budget process is the most interesting aspect of state government. It includes significant policy discussions. It demonstrates some of the rawest form of politics (one need only look back on the rancorous Conference Committee discussions of 2002, which lasted from April 16 until July 2). And it includes the essential ingredient for any epic story: money.

The process used to produce state budgets has been in place since 1911. The “modern” era of budgeting dates to the early 1970s when the Legislature enhanced its support staff and became truly independent of the Executive branch. Until recently the process served state government well, weathering both the highs and lows of the economy. But that process is failing. It has yielded a series of biennial budgets focused on the short-term, and that has led to the current \$3.2 billion deficit. It has ensured neither fiscal stability nor dependability in the eyes of citizens.

A sweeping change is needed to right the process. Small changes will not do. Pinning the state’s hopes on a generous revenue forecast will not do. The budget must be developed through a process in which financial considerations are primary and policy and politics are secondary. Such a process will require the key players to relinquish some of their authority. It will require recognition that state government is an enormous fiscal enterprise that must use the most sophisticated techniques available. The following are the steps needed to make that change and avoid future crises.

Establish a Bottom Line

Government is lacking a fundamental tool that is available to private businesses: a bottom line. Profits drive most financial decisions made in the private sector including what product mix to produce, how many people to employ, how much capital investment to make, where and when to expand, etc. Annual budgets are not developed in a vacuum. They are near-term steps needed to meet the longer-range plan.

Wisconsin state government has no bottom line. Or, viewed another way, it has too many bottom lines. The Governor and Legislature, as soon as the ink is dry on the current budget, should turn their attention to setting Wisconsin’s bottom line. State government needs a long-range fiscal plan within which future budgets can be developed. Without such a plan the goal of each budget will continue to be to live within forecasted revenues. We are now living with the negative results of that type of short-term budgeting.

The concept of the long-range plan is simple; to set a goal of how much state government (or state and local government) can spend and tax its citizens over an extended period. Examples of longer-range goals would be tying state spending to a percentage of per capita personal income in Wisconsin. Or, as the Expenditure Commission in the 1980s suggested, spending should be no more than the median among states as measured by spending per \$1,000 of personal income. (A thumbnail calculation shows that in 1999, the most recent year for which data is available, state and local government spending in Wisconsin was 7.1% above the national average. In that year spending in Wisconsin was \$2.4 billion above the U.S. average.²⁴)

There are a number of very complex factors to consider in selecting the bottom line. Some will be found in a review of history, and some will require an analysis of future mega-trends. It is not the purpose of this paper to recommend what that goal is but rather to promote the establishment of a bottom line.

It is important that, regardless of the goal chosen, it must be independent from short-term revenue forecasts. We now understand the wild ride the volatility of state revenues produces.

Also, the plan must be formalized. In the short term it should be codified in state statutes. Strong consideration should be given to subsequently adopting it as a constitutional amendment, similar to the balanced budget requirement. It is imperative that the long-range plan has teeth. To that end, a provision should be included which prohibits future governors or legislatures from exceeding the long-range spending guidelines. The enforcement of the guidelines should be assigned to the Economic Council that is outlined in the next section.

A key problem with current budgeting procedures is that the parameters provided by the balanced-budget requirement have proven inadequate and have led to feast-or-famine budgeting. Setting an enforceable long-range fiscal target would provide an additional, and more comprehensive, parameter for construction of future budgets.

In developing Wisconsin's bottom line, the public should be actively engaged. It is also important to have the input from a wide range of analytical perspectives, both national and regional. However, it is imperative that this task be done as soon as possible. It must be the foundation for the 2005-07 biennial budget. Planning for that budget will begin in 2004.

What would be done with revenue collections that exceed the amount needed to fund the long-range spending plan? This revenue should be allocated to an account at the State of Wisconsin Investment Board (SWIB) for long-term investment. This account would constitute one element of the state's budget reserve fund. Moving money out of the fund either for spending or for tax cuts should require a supermajority vote of the Legislature as well as action by the Governor. The surplus revenue should not be allocated to the state's cash management account with SWIB, since the return on that fully liquid account is too low and the funds too accessible.

If revenues are inadequate to fund the long-range spending plan, future budgets could either access the budget reserve funds or reduce spending. However, with the discipline of the long-range spending plan, it is unlikely that spending reductions would begin to approach the magnitude of cuts of the current budget.

Economic Council

The idea of an economic council is not new. Many states use councils to assist in forecasting and other financial matters. However, the concept is new to Wisconsin. As noted above, revenue forecasting is done by the Department of Revenue and the Legislative Fiscal Bureau. The council would include these two professional entities as well as others in doing the hands-on economic forecasting and analysis.

The council should include the Directors of the Legislative Fiscal Bureau and the Legislative Audit Bureau, the State Budget Director, the Secretary of Revenue and three financial experts from the university and business communities. Their charge would include providing the official state revenue forecast. Forecasts would be done quarterly in an open forum.

The Council responsibilities would also have a significant tie-in with the state budget. It would be responsible for translating the long-range spending plan into spending parameters for each biennial budget. The Governor and the Legislature would be required to produce a budget within those parameters. The Council would also be required to approve the expenditure of funds from the state's budget reserve fund.

The Council would also review larger trends (e.g., demographics, pharmaceutical costs, the state's economic mix), note challenges appearing on the horizon, and suggest changes to the bottom-line plan. Finally, the Council would determine when revenue reductions would be prudent.

Budget Reserve Funds

As soon as possible, state government should reestablish the requirement to include a 2 percent uncommitted balance in each budget. This small reserve will smooth the incidental changes in revenues and expenditures.

The more substantial budget reserve fund (often considered a rainy-day fund) should be funded at \$1 billion in 2003 dollars. This is \$1 billion more than the fund includes today. A reserve of this magnitude would allow state government to withstand approximately one and one-half years of stagnant revenues. This reserve, in conjunction with the long-range financial plan, would ensure stability in the state's ability to provide a realistic level of services to Wisconsin.

It will take time to build up a reserve fund of this magnitude. A reasonable goal would be to have the reserve fully funded by the end of the decade. A tangible plan should be developed for when regular deposits will be made into the fund.

Use of One-Time Revenues

Part of the current budget deficit is the result of funding continuing spending commitments from one-time revenues. This practice has supported spending at a level that is not sustainable. In the future, one-time revenues should only be used to fund the budget reserve. This is consistent, since the reserve is to be used only to buffer the effects of significant revenue declines.

However, consideration could be given to having certain one-time funding sources pulling double duty. For example, the current budget before the Legislature proposes the use of revenue from the Patient Compensation Fund to support MA expenses. An alternative would be to include funding from the Patient Compensation Fund to help fund the budget reserve. It could assist in building up the rainy-day fund while at the same time it is available to meet malpractice claims. To the extent that the revenues are needed to pay claims, the use of the money to fund the budget reserve would be diminished. However, those who have an interest in the Patient Compensation Fund would be on notice that some funds might be used to repair a future budget.

Spending Controls

Statutes currently specify spending controls that apply to state government and to local governments and schools. The need for these controls should be reviewed in establishing a long-range financial plan. Until that plan is finalized there should be no changes to any spending controls.

GAAP Budget

It has been argued that the state budget should be changed from a cash basis to an accrual-based budget. While this is a noble goal, it is more important to set a long-range sustainable spending plan and to adequately fund a budget reserve. Therefore, it should be a goal in state budgeting to reduce the GAAP deficit, with an eventual target being changing the official state budget and accounting system to GAAP accounting.

Performance Measures

Wisconsin's budget is lacking an objective way to assess current spending in order to provide input to reallocation possibilities. This will require commitment from the Governor and the Legislature; otherwise it is not worth doing. Performance measures should initially be targeted to a few bigger-ticket spending items and should be developed by professional staff that has the confidence of the executive and legislative branches. Efforts should focus on developing measures of program effectiveness and relevancy. While this is an extremely important step, it is secondary to the other changes outlined above.

Urgent Action

The Governor and the Legislature cannot consider their work completed when the 2003-05 budget is signed into law. Producing a balanced budget for the next two years, while enormously challenging, is not enough. The job will not be done until a long-term bottom line for Wisconsin spending and taxing is established. This is the only way to deal honestly with the millions of people who depend on the state budget. Currently, almost every interest group that depends on the state budget for support expects that once this budget is solved, things will return to normal. That will not happen.

Legislation should be passed by the end of 2003 to set long-range spending guidelines for Wisconsin. Action cannot be delayed beyond that time because these changes will be needed to produce the next biennial budget, the planning for which will commence early in 2004. In addition to codifying the long-range spending goal, the legislation should include provisions creating the economic council and restricting the future use of one-time revenue. These three changes are the most critical. Adopting legislation with these changes will fundamentally change budgeting in Wisconsin and provide for sustainable, dependable budgets from that time forward.

SUMMARY

Outlined above are fundamental changes to the method now used to produce a Wisconsin state budget. These changes would undoubtedly bring more discipline to the process and would almost certainly avoid the feast-or-famine budgeting we are experiencing today. However, the prescribed changes amount to very strong medicine.

In an almost macabre sense, there is likely to be resistance to changing the way budgets are constructed. The key players have become accustomed to the predictability of the current process. This includes interest groups, state agencies as well as elected officials. So, even though the current process has yielded results that satisfy no one, it is unlikely that there will be a groundswell of support for changing the process. Further, the next budget cycle is likely to find us facing another large deficit that will re-energize all of the uncertainty and pain that the current budget discussions have engendered.

Now is the moment to change the system: to bring more predictability and certainty into the process, to make the state budget something on which all Wisconsinites can depend. It will require a good deal of innovative thinking, flexibility, and statesmanship to develop the long-range fiscal plan that will spell an end to feast-or-famine budgeting. No changes of this magnitude have been made for several decades. The opportunity for reform is clear.

If the process is not changed, Wisconsin's citizens will be obliged to look on, with fingers crossed, as budgets careen from one revenue forecast to the next.

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NOTES

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ABOUT THE INSTITUTE

The **Wisconsin Policy Research Institute** is a not-for-profit institute established to study public-policy issues affecting the state of Wisconsin.

Under the new federalism, government policy increasingly is made at the state and local levels. These public-policy decisions affect the life of every citizen in the state. Our goal is to provide nonpartisan research on key issues affecting Wisconsinites, so that their elected representatives can make informed decisions to improve the quality of life and future of the state.

Our major priority is to increase the accountability of Wisconsin's government. State and local governments must be responsive to the citizenry, both in terms of the programs they devise and the tax money they spend. Accountability should apply in every area to which the state devotes the public's funds.

The Institute's agenda encompasses the following issues: education, welfare and social services, criminal justice, taxes and spending, and economic development.

We believe that the views of the citizens of Wisconsin should guide the decisions of government officials. To help accomplish this, we also conduct regular public-opinion polls that are designed to inform public officials about how the citizenry views major statewide issues. These polls are disseminated through the media and are made available to the general public and the legislative and executive branches of state government. It is essential that elected officials remember that all of the programs they create and all of the money they spend comes from the citizens of Wisconsin and is made available through their taxes. Public policy should reflect the real needs and concerns of all of the citizens of the state and not those of specific special-interest groups.