WISCONSIN'S Structural DEFICIT

Our Fiscal Future at the Crossroads

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The Wisconsin Legislature is currently attempting to close a $1.1 billion deficit in the state's 2001–03 biennial budget. The causes of the deficit most frequently cited have been the recession and the tragic events of September 11. If the slow economy were in fact the major cause of the deficit, then as soon as the economy recovers, we should expect that the state's deficit problems should also disappear. The sad fact is that the cause of Wisconsin's state government budgetary woes are more deep-seated and will still be with us for a long time after the economy recovers.

In the simplest terms, budgets are in deficit when the amount of money the state spends exceeds the revenues it takes in. The state spends money in order to provide services to state residents. These services include everything from maintaining state parks, imprisoning criminals, and subsidizing health care for poor families to helping to provide a university education for our children. In addition, a substantial portion of state spending is in the form of grants to local school districts and to county and municipal governments. These grants both subsidize public education and municipal and county government services and help reduce the property tax burdens on Wisconsin residents.

To predict what the state's budget will look like in future years, we need to start by figuring out how much the state will have to spend each year in order to continue providing the same services that it provides state residents today. I call this the state's *current services budget*. Spending, at least for some types of services, will rise over time because the state population rises. Thus, if the number of students educated by the University of Wisconsin System rises, the current services budget for higher education will need to increase. Rising costs for goods and services purchased by the state will also result in increases in current service budgets. For example, steep increases in energy prices or in medical insurance for state employees will increase the amount of money needed by the state to maintain current services.

Wisconsin faces a *structural deficit* whenever the amount of money needed to maintain current services exceeds the revenue generated by the state's current tax system. In this article, I show that even under very conservative assumptions about budget growth and reasonably optimistic assumptions about revenue growth, the state will face a very large structural deficit during the next biennium. If no efforts are made to reduce the structural deficit during the next biennium, annual structural deficits will continue through fiscal year 2009–10.

As I explain in more detail below, the state has faced a structural deficit at least since the mid–1990s. A series of fortunate circumstances, in particular, stronger than expected economic growth, have allowed us to put off the hard choices necessary to eliminate the structural deficit. Although no final decisions have been reached, it now appears

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that the legislature and the governor will "solve" the state's current fiscal problems primarily by using a one-time source of funds (the tobacco settlement). Using non-recurring sources of revenue and budget gimmicks does nothing to reduce the underlying structural deficit.

The state's economy should rebound strongly over the next couple years. Even under the most optimistic economic assumptions, however, economic growth will not generate enough extra tax revenue to eliminate the structural deficit. We have certainly run out of short-term budgetary fixes and one-time pots of money. The day of reckoning will come in 2003. We will no longer be able to put off the hard choices that will be necessary to eliminate our structural deficit.

Calculating the State's Structural Imbalance

The starting point for these calculations is the amount of state spending through the General Fund in the most recently completed fiscal year—fiscal year 2000–01, which ran from July 1, 2000 through June 30, 2001. For each of the state's major spending programs, we determine the minimum amount of money that will be needed each year to maintain the level of public services provided in the base year (2000–01). The sum of these amounts is referred to as the *current services* budget. Next, we calculate how much General Fund revenue will be collected in each year if no changes are made in the tax system used in 2000–01. This means that the 2000–01 tax rates, exemptions, and other features of the tax code remain in force. In any year in which the current services budget exceeds the available revenues under current laws, a *structural deficit* will occur. A *structural surplus* will occur in any year when available revenues exceed current services expenditures.

The following paragraphs explain the assumptions that I made in order to project a current service budget and available revenues for each fiscal year from 2001–02 through 2010–11.

Estimating a Current Services Budget

In calculating the state's current service budget for the next 10 years, I have made a number of quite conservative assumptions about the growth of costs of providing public services. The specific assumptions are outlined below. Projecting future costs for every state government program between now and 2011 would be a Herculean task. The approach I follow here is to make separate estimates for each of the five largest General Fund programs. I then make the simple assumption that the *real* (inflation adjusted) costs of maintaining all other state government programs funded through the General Fund remains constant between now and 2011 with the exception of a proportional adjustment for projected annual growth in state population over that period.

For fiscal year 2000–01, the five largest General Fund programs in order of size were: (1) state aid for elementary and secondary (K–12) public education, (2) Medical Assistance (health care for the needy), (3) the University of Wisconsin System, (4) shared revenue (state aid to municipal and county governments) and (5) corrections. Together these five programs accounted for 74 percent of General Fund expenditures. The assumptions underlying the real growth in the costs of current services for each of these programs are listed below:

- K–12 Public Education. In 1996, in addition to its commitment to fund two-thirds of the cost of K–12 education, the legislature enacted a permanent revenue cap, limiting the annual amount by which school districts can increase school revenues and hence expenditures. The data show that the revenue cap has been successful in restraining the growth of school spending. During the first half of the 1990s, the annual rate of growth of General Fund expenditures on K–12 education averaged 3.1 percentage points above the rate of inflation. Between 1995

and 2000, average annual expenditures grew at a rate of 2.5 percentage points above the rate of inflation. A heated debate is raging over whether the revenue caps are preventing school districts from maintaining the quality of public education. For the purposes of this exercise, I make the conservative assumption that over the next decade school districts will be able to maintain the current quality of education with an annual *real* increase in state school aids of 1.25 percent—a rate that is one-half of the rate of real expenditure growth during the second half of the 1990s. Official demographic projections indicate that over the next decade, the number of school-aged children in Wisconsin will be declining by a modest amount. The current service budget projections for K–12 education also assume that expenditures on state education aid will decline proportionately to the projected fall in enrollments.

- Medical Assistance. Predicting the costs of Medical Assistance expenditures is particularly difficult. It is necessary not only to predict changes in the number of persons eligible for Medical Assistance, but also to predict changes in the annual costs of health care. After a period of relatively modest growth in the late 1990s, the rise in health care costs appears to be accelerating rapidly. Nevertheless, in developing a current services budget for Medical Assistance, I have assumed that the real annual growth in General Fund expenditures on Medical Assistance will grow at a rate proportionate to the projected growth in the population of the state and the average percentage amount by which the medical care price index exceeded the consumer price index during the 1991–2001 period. These calculations result in a real increase in Medical Assistance expenditures of around 2 percent per year.

- University of Wisconsin System. As a means of maintaining the quality of education, the Regents of the UW System have placed caps on the annual growth of enrollment through 2006. For the years between 2007 and 2011, I have assumed an annual enrollment cap increase of 0.17 percent, a figure that is the average of the annual growth in the enrollment cap for the years 2002 to 2006. In each year, the caps are considerably lower than projected growth in state population. In calculating the current services budget for the UW System, I have assumed that real spending will increase by the annual increases in enrollment allowable under the caps and by the average amount by which the government's higher education price index (HEPI) exceeded the CPI (Consumer Price Index) during the 1990s.

- Shared Revenue. General Fund allocations to the shared revenue program provide all county and municipal governments in Wisconsin with grants. In general, larger per capita grants go to local governments with the smallest property tax bases. The Kettl Commission and others have suggested that there are good reasons to reform the formulas used to allocate shared revenue among local governments. Despite these criticisms, there is little question that reductions in the real value of shared revenue allocations leads to either cuts in local government public services or to increases in local government property taxes and fees. A reasonable argument can be made that, on average, the real costs of providing municipal and county services grow proportionately with the growth of population. Thus, in calculating a current services budget for shared revenues for the 2002 to 2011 period, I assume that real per capita shared revenue spending will remain constant, i.e. real spending on shared revenue will grow at the same rate as the state's population.

- Corrections. Starting in the late 1980s, the legislature took a number of steps designed to increase the prison sentences of convicted criminals and to reduce their access to parole. As a result of these "get tough on crime" policies, between 1987 and 2001, the number of inmates in state prisons grew at an average annual rate of 9.36 percent. This rapid growth in prison population was reflected in a steady increase in state spending on corrections. In projecting a current services budget for corrections for the 2002 to 2011 period, I will make the conservative assumption that the real growth in corrections spend-

FIGURE 1

General Fund Expenditures in 2002 Dollars

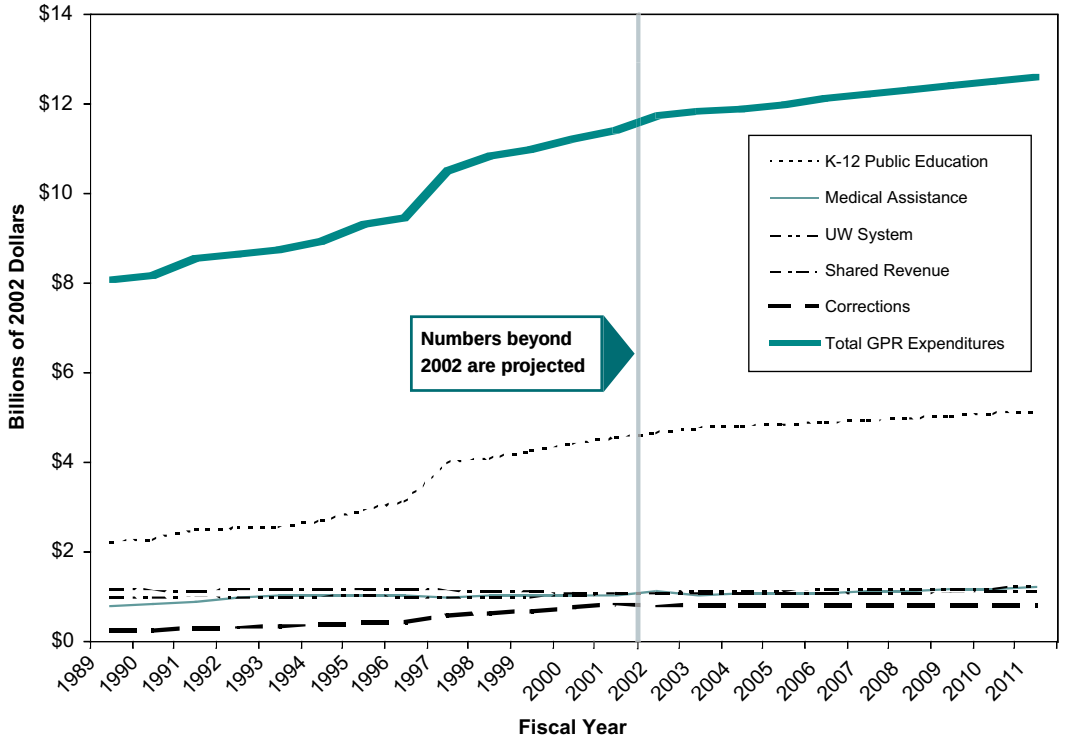

Figure 1 combines actual data on General Fund expenditures between fiscal years 1989 and 2001 with my projected current service budgets for fiscal years 2002 to 2011, all expressed in constant 2002 dollars. The data show that during the 1990s the largest growth in spending (after controlling for the impact of inflation) occurred in state expenditure on K–12 education and in spending on corrections. The big jump in education spending took place in fiscal year 1997 when the state implemented its commitment to finance two-thirds of education costs. The data in Figure 1 also show that during the 1990s there was almost no real expenditure growth in state funding for Medical Assistance, the UW System, and for shared revenue.

The assumptions outlined above result in a current services budget that is projected to grow at an annual average rate of only 0.83 percent above the rate of inflation. The data in Figure 1 shows that the average annual rate of real growth of General Fund spending between fiscal years 1989 and 2001 was equal to 2.9 percent per year. This pattern of spending growth suggests that continuing to provide current levels of public services over the next decade while constraining the real rate of spending growth to under one percent per year will require substantial gains in the efficiency with which public services are delivered. To the extent that these efficiency gains cannot be achieved, the current services budget will grow at a faster rate than assumed here, and the *structural deficits* reported below will be underestimated. For example, if the real current services budget were to grow at an annual rate of two percent over the next decade (instead of 0.83

ing can be kept to the projected growth rate of population over this period—a rate that averages less than one-half of 1 percent per year.

- All Other Programs. I assume that the real cost of all other programs financed through the General Fund will grow at the projected rate of state population growth. This is equivalent to assuming constant real per capita spending between 2002 and 2011. Again this is a quite optimistic assumption. Between 1996 and 2000, real per capita spending financed by the General Fund grew at an average annual rate of 1.27 percent. Thus, the assumption that current services can be maintained with no growth in real per capita spending requires that the state increase the efficiency in the delivery of services by enough to offset any growth in state employee wages and benefits or in the costs of other inputs, such as fuel, that exceed the growth in the consumer price index.

percent), the structural deficit for the next biennium would be 25 percent greater than the deficit projection in this report.

Estimating Future Revenues

The best way to predict the amount of revenue our tax system will generate is to look at the historical relationship between tax revenue and personal income growth. Largely because of Wisconsin's relatively heavy reliance on the individual income tax, tax revenue tends to grow at a faster rate than personal income. Although precise calculations are difficult, a careful analysis of data on personal income growth and tax revenue growth over the past decade led me to assume a *revenue elasticity* of 1.115. This means that each 1 percent increase in real personal income will lead to a 1.115 percent increase in General Fund tax revenue. The basis of the revenue projections used in this report are the latest long-run projections of real growth in personal income released by the Wisconsin Department of Revenue. Those projections (dated February 28, 2002) indicate that the Wisconsin economy will improve dramatically over the next couple years. Projected growth in real personal income will increase from 1.1 percent in 2002 to 2.2 percent in 2003 and 2.6 percent in 2004. If the economy grows at a faster than projected rate, the structural deficits reported below will be reduced. If, however, the economic recovery is slower than anticipated, the structural deficits during the next biennium will be larger than indicated. The detailed spending and revenue projections through fiscal year 2011 are displayed in Table 1.

TABLE 1

Wisconsin's General Fund Structural Imbalance, 2001-02 to 2010-2011

(In millions of dollars)

	In current dollars		In 2002 dollars							
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
REVENUE										
Opening Balance	$207.5	$138.1	$137.2	$131.1	$134.9	$137.9	$140.7	$143.5	$146.4	$149.4
Estimated Revenue	$10,610.1	$10,951.7	$11,058.9	$11,379.6	$11,633.4	$11,867.0	$12,105.2	$12,348.2	$12,596.1	$12,849.0
Available Revenue	$10,817.6	$11,089.8	$11,196.1	$11,510.7	$11,768.4	$12,004.9	$12,245.9	$12,491.7	$12,742.5	$12,998.3
APPROPRIATIONS										
K-12 Public Education	$4,594.7	$4,763.6	$4,799.7	$4,836.1	$4,885.9	$4,936.2	$4,987.1	$5,038.4	$5,090.3	$5,142.7
Medical Assistance	$1,106.7	$1,024.3	$1,046.7	$1,069.6	$1,091.0	$1,112.8	$1,135.0	$1,157.7	$1,180.9	$1,204.5
UW System	$1,058.3	$1,115.6	$1,124.7	$1,135.0	$1,145.4	$1,155.1	$1,165.3	$1,175.5	$1,185.9	$1,196.3
Shared Revenue	$1,047.8	$1,062.4	$1,068.5	$1,074.5	$1,078.7	$1,082.8	$1,087.0	$1,091.1	$1,095.3	$1,099.5
Corrections	$770.9	$786.1	$790.6	$795.0	$798.1	$801.2	$804.2	$807.3	$810.4	$813.5
All Other Programs	$3,010.4	$3,069.9	$3,087.4	$3,104.9	$3,116.8	$3,128.8	$3,140.8	$3,152.9	$3,165.0	$3,177.1
Total Current Service Appropriations	$11,588.8	$11,821.9	$11,917.5	$12,015.2	$12,115.9	$12,216.9	$12,319.4	$12,423.0	$12,527.8	$12,633.7
Annual real growth in appropriations			0.81%	0.82%	0.84%	0.83%	0.84%	0.84%	0.84%	0.85%
BALANCES										
Revenue - Appropriations	-$771.2	-$732.1	-$721.4	-$504.4	-$347.5	-$212.0	-$73.5	$68.7	$214.7	$364.6
Required Reserves (1.2%)	$138.1	$137.2	$131.1	$134.9	$137.9	$140.7	$143.5	$146.4	$149.4	$152.4
Net Balance	-$909.3	-$869.3	-$852.5	-$639.4	-$485.5	-$352.7	-$217.0	-$77.7	$65.4	$212.2
Annual Structural Deficit (estimated revenues - current services-reserves)	-$909.3	-$1,007.4	-$989.7	-$770.5	-$620.4	-$490.7	-$357.7	-$221.2	-$81.1	$62.9
Structural deficit/estimated revenue	8.6%	9.2%	8.9%	6.8%	5.3%	4.1%	3.0%	1.8%	0.6%	-0.5%

The Results

In any given year, a structural deficit exists if the sum of the current services budget for that year plus the required 1.2 percent reserve exceeds estimated general fund revenues. As shown in Table 2, the structural deficit averages about $950 million per year over the current biennium. In fiscal year 2003–04, the first year of the next biennium, the state will face a structural deficit of nearly $990 million (measured in 2002 dollars). If nothing is done to close this structural deficit, the state will face a structural deficit of about $770 million in fiscal year 2004–05. Over the course of the biennium, the structural deficit will be $1.75 billion. This amount equals 7.8 percent of the total General Fund revenue that would be raised during the biennium assuming no changes to current tax law.

The calculations summarized in Table 2 also reveal that without remedial action, annual structural deficits would occur in every fiscal year through 2009–10. Because I have assumed that General Fund revenues will grow at a faster rate than the state's current services budget, the projected structural deficits will become smaller with each passing year.

As this report is being written, a conference committee of the legislature is trying to reconcile the differences between the Assembly and Senate versions of 2001–03 budget adjustment bill (formally, the Budget Reform Bill.) Because the final bill that is passed by the legislature and signed by the governor will presumably include elements of both the Senate and Assembly budget bills, the general outline of the revised 2001–03 budget is quite clear. Most of the money needed to close the current budget deficit will come from one-time sources of revenue. By far the largest source of these one-time funds comes from the state's share of the tobacco settlement. The multi-state settlement with the major tobacco companies resulted in an agreement that the states would receive a stream of annual payments from 2000 through 2032. Wisconsin has decided to convert this stream of promised payments into a one-time, up-front payment (referred to as securitizing the tobacco settlement). It accomplishes this by in effect issuing bonds whose debt payments are met by the flow of tobacco settlement payments. Most of the

TABLE 2

Wisconsin's General Fund Structural Imbalances

(in millions of 2002 dollars)

Fiscal Year	Estimated Revenue	Current Services Budget*	Structural Imbalance
2001-02	$10,817.6	$11,726.9	**-$909**
2002-03	$10,951.7	$11,959.1	**-$1,007**
2003-04	$11,058.9	$12,048.6	**-$990**
2004-05	$11,379.6	$12,150.1	**-$770**
2005-06	$11,633.4	$12,253.8	**-$620**
2006-07	$11,867.0	$12,357.6	**-$491**
2007-08	$12,105.2	$12,462.9	**-$358**
2008-09	$12,348.2	$12,569.5	**-$221**
2009-10	$12,596.1	$12,677.2	**-$81**
2010-11	$12,849.0	$12,786.1	**$63**

*** Includes 1.2 percent required reserve.**

Source: See text.

proceeds of the bond sale are then used to finance the current budgetary shortfall.

Because the use of one-time funding does nothing to increase future revenue flows or reduce the current services budget, it will have no impact on the size of the structural deficit. The 2001–03 budget compromise will almost certainly include some modest reductions in the permanent funding level for existing state programs. Although these spending cuts will reduce my estimate of the structural deficits for the 2003–05 biennium, it is unlikely that they will reduce the estimates by more than $200 million—leaving a structural deficit in 2003–04 of over $700 million and a structural deficit for the whole biennium of well over $1 billion.

Can Economic Growth Solve Our Structural Deficit Problems?

The structural deficit projections made in this report are based on the assumption that the state's economy will begin recovering this year, with the economic recovery continuing over the next couple years. By 2004, real personal income is projected to grow at a rate of 2.6 percent. During the second half of the 1990s, the state's economy grew at an extremely fast rate, with the rate of real economic growth peaking in 1998 at 4.2 percent. During the three-year period, 1997 through 1999, personal income grew at an average annual rate of 3.6 percent.

Although economists think it is highly unlikely that the Wisconsin economy will be able to grow at anywhere near that rate, what if such a rate of growth was in fact sustainable in both 2003 and 2004? If the economy grew at an annual rate of 3.6 percent (in real terms), would this rapid economic growth solve our structural deficit problems? The answer is decidedly no. The structural deficit would decline by about $150 million in 2003–04 and by about $275 million in 2004–05, but the total structural deficit over the course of the biennium would still add up to $1.3 billion.

Why Does Wisconsin Have a Structural Deficit?

It is not difficult to identify the major elements that have contributed to the current fiscal situation. In 1994, in response to a growing public frustration with rising school property taxes, the legislature committed the state to pay two-thirds of the cost of primary and secondary public education beginning in the 1996–97 school year. To fulfill this promise, the state had to increase grants to school districts by a total of $1.2 billion in fiscal year 1997. During the early and mid–1990s, the legislature was also "getting tough on crime" by instituting longer sentences on convicted criminals and restricting access to parole. Largely as a consequence of these stiffened sentencing rules, the state's prison population grew from nearly 6,000 in 1987 to nearly 21,000 at the end of 2001.

While both of these policies committed the state to substantial increases in spending, the legislature failed to reduce spending on other state programs or to make changes in our tax system designed to fund these new commitments. During the latter half of the 1990s, the legislature was able to avoid making these difficult choices because the booming economy was producing unanticipated additional tax revenue with which to balance each biennial budget.

During the late 1990s, most states were using at least a portion of their unexpected tax revenue to invest in so-called "rainy day" funds. Wisconsin, however, was one of only five states that chose to put nothing away for a time when the economy stopped growing. Although legislation authorizing the establish-

ment of a *stabilization fund* has been on the books for a number of years, no money has been deposited in the fund. In fact, during the late 1990s, the legislature enacted a multi-year individual income tax reduction, exempted some additional goods and services from the sales tax, authorized a sales tax rebate, and instituted a number of business tax breaks. Regardless of the merits of these tax policy changes, their net effect was to increase the size of the state's structural deficit.

Conclusion

Over the past few biennial budgets, the legislature has been able to put off making the difficult choices that are required to eliminate the structural deficit. First, the extraordinary economic growth during the late 1990s and then the ability to use up the tobacco settlement have allowed the state to balance the past few biennial budgets. It is hard to imagine, however, any source of revenue suddenly materializing to bail out the state once again. Come 2003, the legislature and the governor will have no choice but to address the state's structural deficit.

State government in Wisconsin has a well-deserved reputation for innovation over a wide range of policy areas. It is widely recognized as a leader in a number of areas such as welfare reform, environmental protection, mental health, social services, and higher education. The citizens of the state are used to receiving high quality public services. Arguably, both individuals and businesses are attracted to the state because of the level and quality of services provided by its state and local governments. The existence of a structural deficit means that as a state we must choose whether we want to reduce the existing level of public services or whether we are willing to collectively pay more money in taxes and fees in order to continue receiving the public services to which we have become accustomed.

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