

Looking Back, Looking Forward: Budget Lessons from Five Midwest States

by David Merriman

Associate Director, Institute of Government and Public Affairs

Professor of Public Administration, University of Illinois at Chicago

This chapter presents an overview of state revenues and expenditures nationwide and in Illinois, Indiana, Iowa, Michigan, and Wisconsin, primarily between FY 1998 and FY 2008. Overall, tax revenue grew slowly or even declined; at the same time, expenditures grew faster than revenue across the board. When spending levels exceed revenue, states experience fiscal crisis. Several promising strategies for stabilizing budgets over the business cycle are discussed: accumulating surpluses or rainy day funds to balance out cyclical downturns, distinguishing between short-term and long-term revenues in the budget process, publishing multi-year budget forecasts, and considering family impacts of budget decisions, particularly on the state's most vulnerable children and families.

Wisconsin is facing a substantial budget shortfall. What can be learned from the 2001 fiscal crisis to inform policy decisions in the current fiscal crisis? Did the decisions made during the last recession lead to long-term harm? What lessons can be drawn from budget trends in five Midwest states over the past decade to help build more sustainable budgets in the future? To frame this discussion, the chapter considers the budget experience of Illinois, Indiana, Iowa, Michigan, and Wisconsin. I look back at the expenditure levels and changes for these five Midwestern states during the 2001-2002 state fiscal crisis. Then I compare and contrast the expenditures and revenues of these same states, primarily for the decade between 1998 and 2008.

Overview of Expenditures and Revenues of Five Midwest States

In this chapter, I focus on Illinois, Indiana, Iowa, Michigan, and Wisconsin, the states that comprise the Chicago Federal Reserve district. I begin by discussing some cross-state differences in revenue sources and expenditure types. I provide data on 11 revenue and spending categories for fiscal year 2008 expressed as a percent of total general revenue. On the revenue side of the budget, I provide data for total general revenue, total tax revenue, individual income tax, corporate income tax, sales tax, and intergovernmental federal transfers to the state. On the expenditure side of the budget, I provide figures for total general expenditures, corrections, and Wisconsin's three main expenditures—K-12 education, higher education, and Medicaid. These expenditures come from the state's General Fund, which is the main fund lawmakers use when putting together the Wisconsin budget. Transportation is another large expenditure, but in Wisconsin it is in a separate fund.

Most of these tables and figures are based on data from the U.S. Census Bureau, widely considered the most accurate information source for comparing state revenues and expenditures.¹ One downside is the two-year lag in the release of

Census data, which means the 2008 numbers in this chapter are the most current available. As shown in Table 1A, the five states all receive between 45.9% and 57.7% of their general revenue from taxes. The balance of state revenue comes from intergovernmental revenues, fees (e.g., airports, toll roads, tuition), and other sources. Of these other revenue sources, only federal revenues are shown.

In FY 2008, Wisconsin spent all of its general revenue, whereas Illinois, Indiana, and Iowa held back some of their revenue.

Several numbers are notable, four of which are mentioned here. First, Wisconsin is more reliant on individual income tax than the other states—getting 23.7% of revenue from that source. Second, as shown in Table 1B, Wisconsin spent all of its general revenue, whereas Illinois, Indiana, and Iowa held back some of their revenue. Third, because of a much heralded shift toward the state and away from local school districts, Michigan spends a greater share of its budget (25.9%) than other states on K–12 education. Finally, corrections spending comprises a greater share of the budget in Wisconsin than in other states, but still accounts for less than 4% of all revenue.

Table 1A. Relative Importance of Selected State Budget Categories—Percent of Total General Revenue

State	Total General Revenue (FY 2008)	Total Tax Revenue (FY 2008)	Individual Income Tax Revenue (FY 2008)	Corporate Income Tax Revenue (FY 2008)	General Sales Tax Revenue (FY 2008)	Intergovernmental Federal Revenue (FY 2008)
United States	100%	51.6%	18.4%	3.4%	15.9%	29.5%
Illinois	100%	57.7%	18.7%	5.6%	14.4%	26.7%
Indiana	100%	51.7%	16.5%	3.1%	19.6%	28.5%
Iowa	100%	45.9%	19.0%	2.3%	12.3%	30.8%
Michigan	100%	50.4%	14.6%	3.6%	16.7%	27.2%
Wisconsin	100%	53.9%	23.7%	3.1%	15.3%	25.1%

Table 1B. Relative Importance of Selected State Budget Categories—Percent of Total General Revenue

State	Total General Expenditure (FY 2008)	K-12 Education Expenditure (FY 2008)	Higher Education Expenditure (FY 2008)	Corrections Expenditure (FY 2008)	Medicaid Expenditure* (FY 2006)
United States	99.2%	20.4%	13.0%	3.3%	9.8%
Illinois	98.3%	15.4%	11.4%	2.3%	10.6%
Indiana	97.2%	16.7%	16.7%	2.3%	7.4%
Iowa	98.8%	20.2%	15.7%	1.9%	7.2%
Michigan	101.4%	25.9%	16.9%	3.8%	8.2%
Wisconsin	100.1%	21.5%	13.5%	3.9%	7.9%

Source: Data for 2008 from U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; Medicaid data for 2006 from the U.S. Centers for Medicare and Medicaid Services, *Financial Management Report*: http://www.cms.gov/MedicaidBudgetExpendSystem/02_CMS64.asp.

Tables 2A and 2B show the annual percentage changes in real (adjusted for inflation) per capita revenue and expenditures for the 11 revenue and spending categories, primarily for the ten-year period from FY 1998 until FY 2008. One could tell many stories with these numbers, but four points are notable. First, total tax revenue is almost the same in Wisconsin in 2008 as it was in 1998. In contrast, total tax revenue decreased in Michigan and increased somewhat in Illinois, Indiana, and Iowa. In most of these Midwest states, these figures were driven by the individual income tax with two exceptions. In Wisconsin, revenue from individual income tax declined slightly and revenue remained almost constant. Indiana experienced declines in individual income tax revenue, but increased its overall tax revenue. Second, despite slow and even negative growth in total tax revenue, real spending grew in each state, and grew faster than revenue in each state except Iowa. Third, in three states, including Wisconsin, corporate income tax revenue declined between 1998 and 2008. Finally, corrections spending in Wisconsin grew at a much faster rate than in the other Midwest states.

Total tax revenue in Wisconsin is almost the same in 2008 as it was in 1998.

Table 2A. Change in Selected State Budget Categories—Annualized Percent Change in Real Per Capita Revenue

State	Total General Revenue (FY 1998-2008)	Total Tax Revenue (FY 1998-2008)	Individual Income Tax Revenue (FY 1998-2008)	Corporate Income Tax Revenue (FY 1998-2008)	General Sales Tax Revenue (FY 1998-2008)	Intergovernmental Federal Revenue (FY 1998-2008)
United States	2.30%	1.68%	2.19%	1.59%	1.03%	2.88%
Illinois	2.15%	2.01%	1.11%	1.85%	0.70%	2.21%
Indiana	2.43%	1.44%	-1.21%	-3.12%	3.06%	4.64%
Iowa	2.72%	0.98%	1.76%	3.09%	-0.77%	4.85%
Michigan	0.56%	-0.97%	-1.24%	-5.20%	-1.69%	1.94%
Wisconsin	1.39%	0.09%	-0.20%	-0.56%	0.43%	3.25%

Table 2B. Change in Selected State Budget Categories—Annualized Percent Change in Real Per Capita Expenditure

State	Total General Expenditure (FY 1998-2008)	K-12 Education Expenditure (FY 1998-2008)	Higher Education Expenditure (FY 1998-2008)	Corrections Expenditure (FY 1998-2008)	Medicaid Expenditure* (FY 1997-2006)	Memo: Population Growth (FY 1998-2008)
United States	2.67%	2.54%	3.59%	1.55%	3.55%	1.00%
Illinois	2.52%	1.61%	3.64%	-1.25%	1.68%	0.47%
Indiana	2.64%	1.12%	1.35%	1.18%	5.59%	0.63%
Iowa	2.35%	2.16%	1.65%	-0.15%	5.16%	0.30%
Michigan	1.28%	-0.04%	2.73%	0.96%	0.95%	0.20%
Wisconsin	2.08%	0.81%	3.00%	2.13%	3.18%	0.61%

Source: Data for 1998-2008 from U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>; Medicaid data for 1997-2006 from the U.S. Centers for Medicare and Medicaid Services, *Financial Management Report*: http://www.cms.gov/MedicaidBudgetExpendSystem/02_CMS64.asp.

Looking Back: What Can We Learn from the State Fiscal Crisis of 2001-2003?

There is consensus among economists and state budget analysts that a widespread state fiscal crisis occurred in 2001. Due to the mild 2001 recession and policy decisions made by state legislatures, total tax collections in the five states were flat or fell from 2000 to 2001, and then fell again from 2001 to 2003. The reasons for these declines in tax collections may vary across states, but in Wisconsin were largely due to policy changes. In FY 2000, there was an unusual spike in personal income tax collections (see Figure 3 on page 13), which can be explained by a change in tax law. Wisconsin got rid of the property/rent credit that year, which sharply increased state revenues. Also, by the late 1990s, substantial surpluses had accumulated following long periods of economic growth. In 1999, Wisconsin enacted an income tax cut, which took effect for tax year 2000 and was fully phased in by tax year 2001. This law cut state income tax revenues by an estimated 11.4%. So Wisconsin's drop in revenues in early 2000 were due, in part, to the mild recession, but to a larger extent to policy decisions.

Despite the decrease in tax revenue, per capita state general expenditures continued to rise in the Midwestern states from 2000 to 2001. Cuts in state spending did not come close to matching tax revenue declines in 2002 and 2003.

State own-source spending increased less as a share of personal income in the 1990s than in any decade since 1949.

The fastest growth areas in spending were K-12 education (i.e., elementary and secondary education), higher education, and Medicaid. However, the levels of spending growth in the 1990s were not unusual by historical standards. In fact, state own-source spending (i.e. spending from taxes, fees, and other state revenue sources) increased less as a share of personal income in the 1990s than in any decade since 1949.² Additionally, real state spending per capita grew at a slower rate in the 1990s than in earlier decades.

Even though spending growth was slow, the level of state spending in 2002 and 2003 was unsustainable with the revenue systems then in place. States faced massive deficits in these years. Temporary fixes were possible and widely exploited, but eventually states had to make policy changes to increase revenue and/or cut spending.

Looking Forward to the Current State Fiscal Crisis

Figures 1 through 11 depict revenues and expenditures of five Midwest states, most of which are annual estimates between 1998 and 2008. These figures provide a broad overview of how Wisconsin compares to several of its neighbors. Using data from the U.S. Census Bureau and the Center for Medicare and Medicaid Services, I provide rough comparisons of the size of state revenue and expenditures. I focus here on only state and not local revenue and expenditures. Comparisons based on combined state and local data are available in Informational Report #74 at the Legislative Fiscal Bureau web site, <http://legis.wisconsin.gov/lfb>.

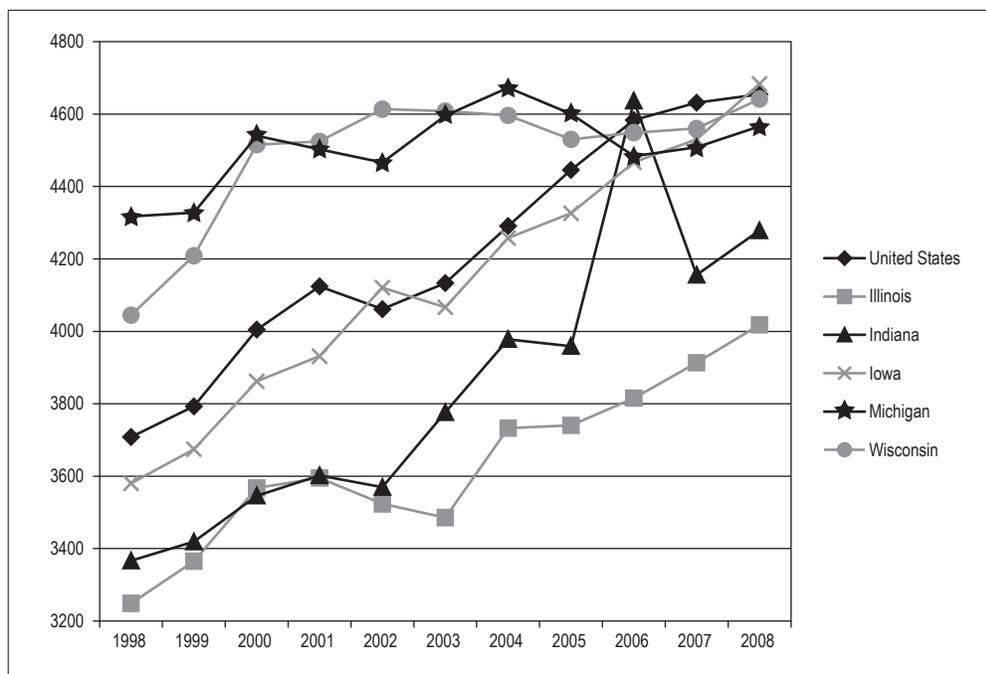
This chapter does not provide an analysis of how dynamic the revenue streams are in putting the state on more secure financial funding in the future. Nor do I explain the effectiveness of the expenditures in each individual state. For example,

it is beyond the scope of this paper to explain what Medicaid expenditures achieve in terms of the proportion of uninsured citizens in the state and the overall health of the population. Similarly, for higher education, I do not compare each state's tuition costs or the return on taxpayer investment (e.g., where the university ranks in cross-state comparisons, how much outside revenue is generated, or what contributions are made to state economic growth). The modest goal of this chapter is to present evidence that can assist policymakers in identifying questions to ask and further information that may be needed. Knowing how past budget decisions in Wisconsin compare with neighboring states may inform future budget decisions.

Wisconsin's transportation expenditures are in a separate fund financed primarily by revenues from the gasoline tax, so they are not graphed here. In comparison to the other five Midwest states, Wisconsin's 2008 per capita expenditures on highways, bridges, tunnels, etc. (not including public mass transit) are in the middle of the pack, behind Iowa and Illinois.

Figure 1 shows real per capita state general revenue over time and across states. It is not surprising that Michigan's per capita general revenue grew slowly because its economy is heavily dependent on the weakened auto industry and it has the slowest population growth rate of the five states (see Table 2B). In contrast, Indiana has relatively robust population growth and rapid growth of real per capita general revenues. Wisconsin has population growth above the five Midwestern states except Indiana, but experienced very slow growth in real per capita general revenues.

Figure 1. State Total General Revenue—Real 2005 Dollars Per Capita



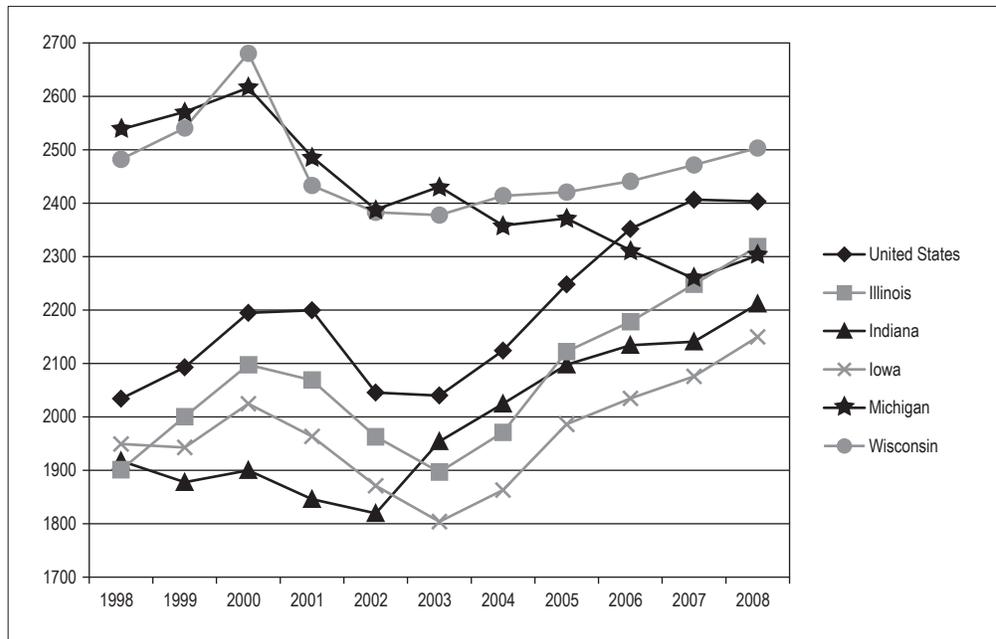
Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>; the jump in total general revenue seen for Indiana in 2006 can be attributed to Indiana selling its toll road during this year.

Wisconsin has population growth above the five Midwestern states except Indiana, but experienced very slow growth in real per capita general revenues.

Figure 2 shows real per capita total tax revenues. Between 2003 and 2008, tax revenue increased at similar rates (averaging 3.4% per year) in Illinois, Indiana, and the United States. Wisconsin’s revenues grew more slowly over that period but remained the highest among these Midwest states. Michigan’s tax revenue declined from being the highest in 2000 to the middle of the pack in 2008.

A recent report from Wisconsin’s nonpartisan legislative Fiscal Bureau ranked states in FY2008 using local and state tax revenues per \$1,000 of personal income. In this ranking of all states, Wisconsin was 13th, Michigan was 23rd, Illinois 24th, Iowa, 25th and Indiana 26th. Wisconsin, however, ranked 42nd in total state and local government revenue per \$1,000 of personal income. The discrepancy between Wisconsin’s two rankings is the result of the state’s relatively high dependency on taxes as sources of government revenue.³

Figure 2. State Total Tax Revenue—Real 2005 Dollars Per Capita

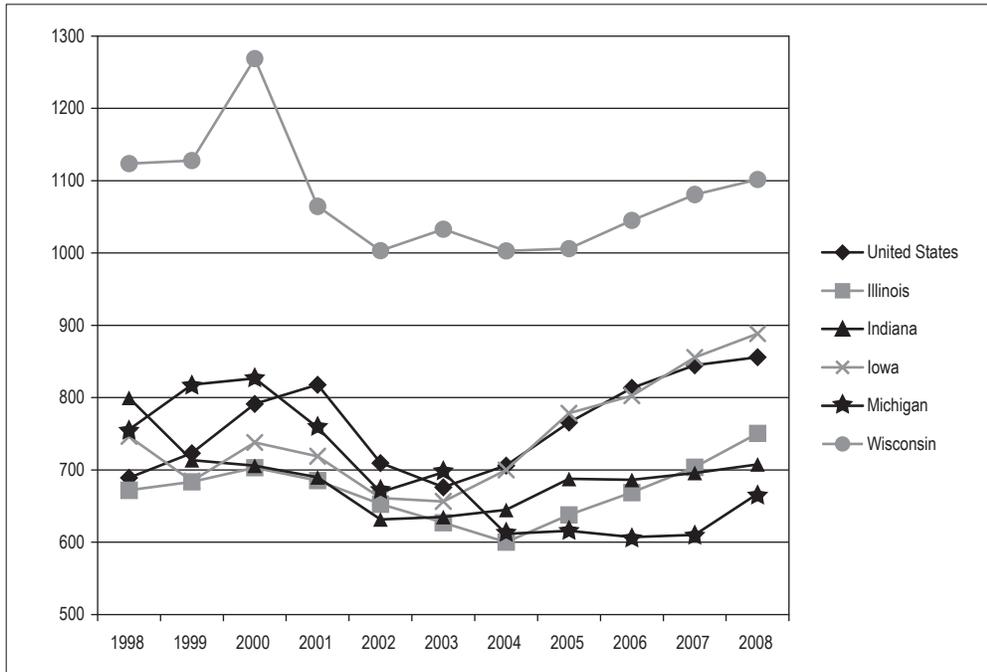


Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

Figure 3 shows per capita individual income tax collections. Wisconsin relies much more heavily on individual income tax and property tax, and less heavily on other revenue sources. Many economists would support this revenue mix because federal tax law allows a deduction for payments of state income tax and property tax. By relying more heavily on state income tax and property tax than other taxes and fees, Wisconsin substantially reduces the federal income tax payments of its residents.

Wisconsin substantially reduces the federal income tax payments of its residents by relying more heavily on individual income tax and property tax for state revenue.

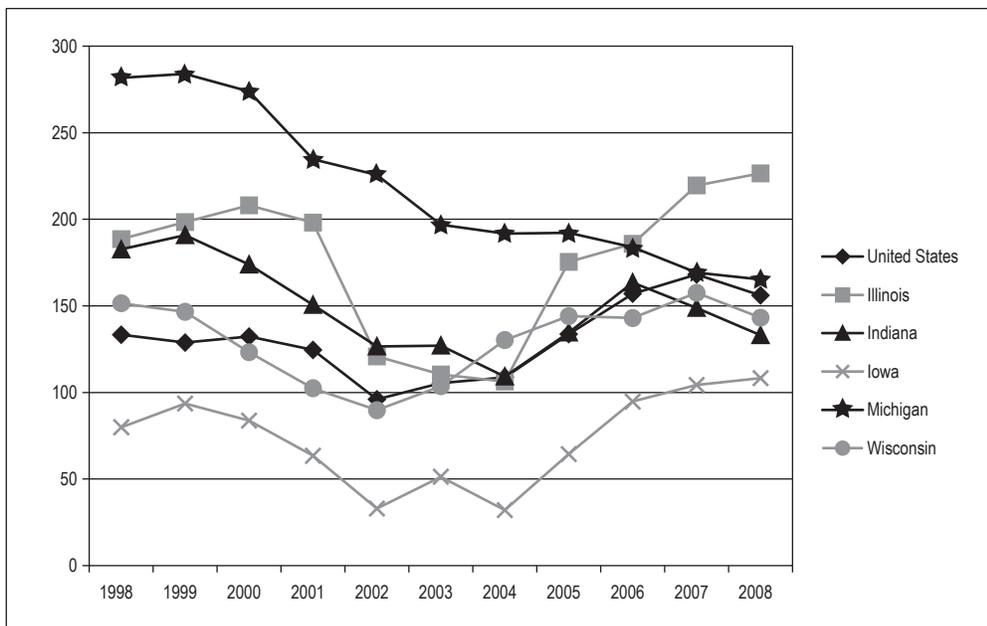
Figure 3. Individual Income Tax Revenue—Real 2005 Dollars Per Capita



Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

As displayed in Figure 4, Wisconsin’s per capita corporate income tax puts them in the middle of the five Midwest states. In contrast, Illinois’s reliance on corporate income tax grew substantially after 2003.

Figure 4. Corporate Income Tax Revenue—Real 2005 Dollars Per Capita



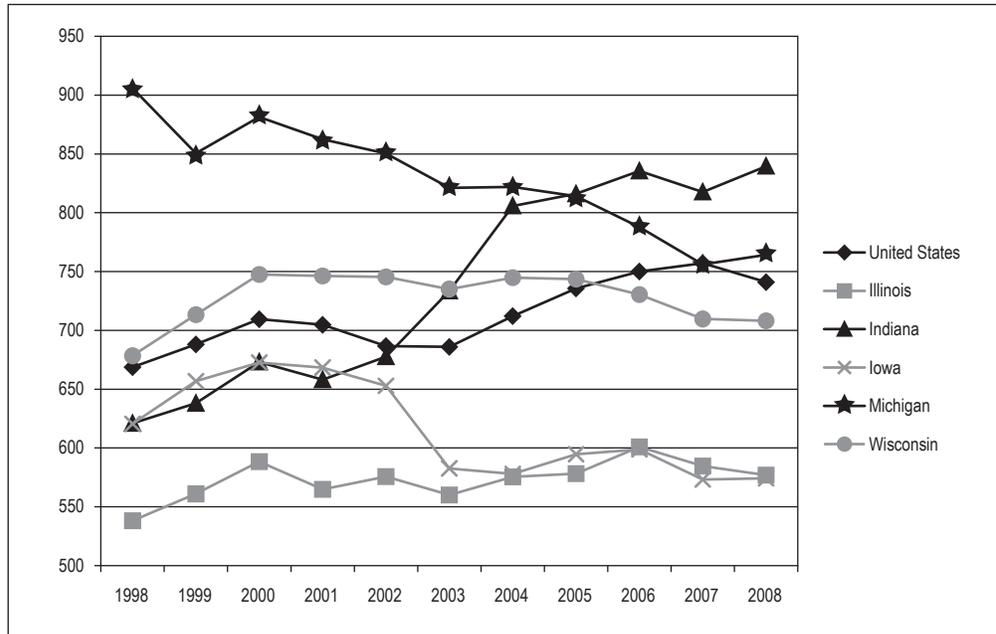
Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

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Wisconsin's per capita corporate income tax puts them in the middle of the five Midwest states.

As shown in Figure 5 (and confirmed in Table 2A), between 1998 and 2008, sales tax revenue grew slowly in Illinois and Wisconsin and declined in Iowa and Michigan. The exception is Indiana, where sales tax revenue grew substantially during the decade. Wisconsin is in the middle of the pack in per capita general sales tax revenue, with revenues declining slightly after 2004. Indiana and Michigan rely more heavily on sales tax revenue than the other Midwest states.

Figure 5. General Sales Tax Revenue—Real 2005 Dollars Per Capita



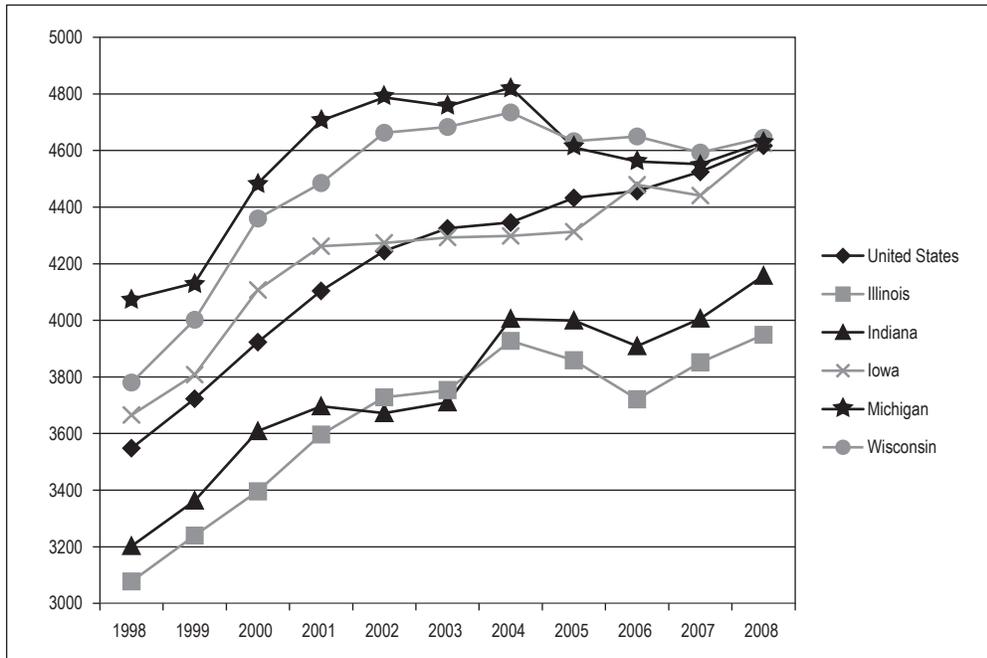
Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

Per capita general expenditures in Iowa, Michigan, Wisconsin, and nationwide all converge in 2008.

Figure 6 shows real per capita state general expenditures. Most of the states followed a fairly steady upward trend though Wisconsin’s and Michigan’s expenditures were relatively flat after 2004. Note that per capita expenditures in Iowa, Michigan, Wisconsin, and nationwide all converge in 2008; per capita expenditures are lower in Indiana and Illinois. When state and local expenditures are combined, Wisconsin ranked 27th nationally per \$1,000 of personal income in FY 2008.⁴ This raises the question of why Wisconsin’s state expenditures are similar to other states, yet its state tax revenues are higher than other states. Part of the answer is found in the next figure, which displays how much intergovernmental revenue Wisconsin received from the federal government.

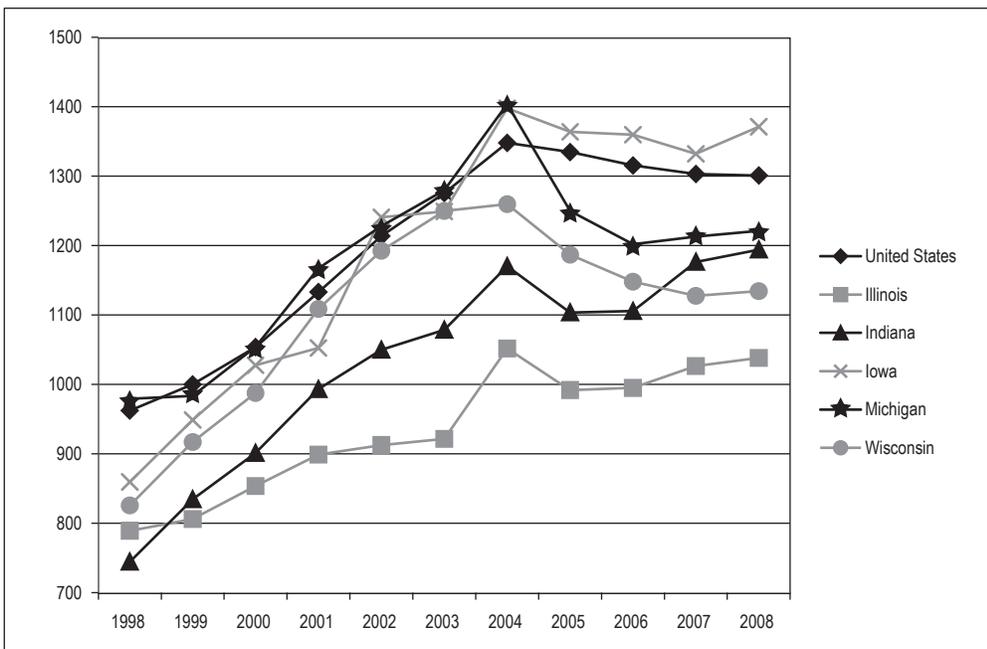
Figure 7 illustrates federal revenue transfers to the states. Wisconsin’s per capita revenues grew steadily until 2004, but declined since that time. Wisconsin’s revenues from the federal government are less than all these Midwest states, except Illinois. In addition, Wisconsin also receives less than some of its neighbors in fees from airports, toll roads, university tuition, and so forth.

Figure 6. Total General Expenditures—Real 2005 Dollars Per Capita



Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

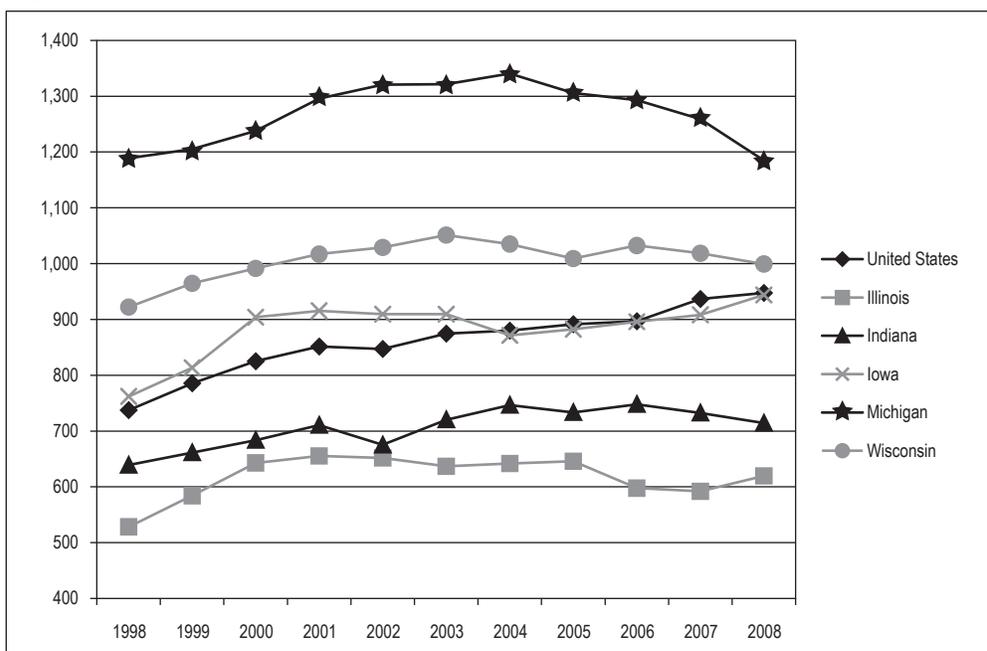
Figure 7. Intergovernmental Revenue from Federal Sources—Real 2005 Dollars Per Capita



Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

Figure 8 shows real per capita state spending on elementary and secondary education. The high level of spending in Michigan results from a swap that exchanged state spending for a decrease in local school district property tax collections. Since 1997, when a new law took effect, Wisconsin too assumed a larger state share of school costs to prevent increases in local property taxes. Not surprisingly, Michigan's and Wisconsin's per capita state spending on K–12 public education is higher than the other Midwest states. When local, state, and federal spending are included, per pupil spending in 2006-2007 is also higher in Wisconsin (\$10,367) and Michigan (\$9,922) than the other Midwest states.⁵

Figure 8. Elementary & Secondary Education Expenditures—Real 2005 Dollars Per Capita



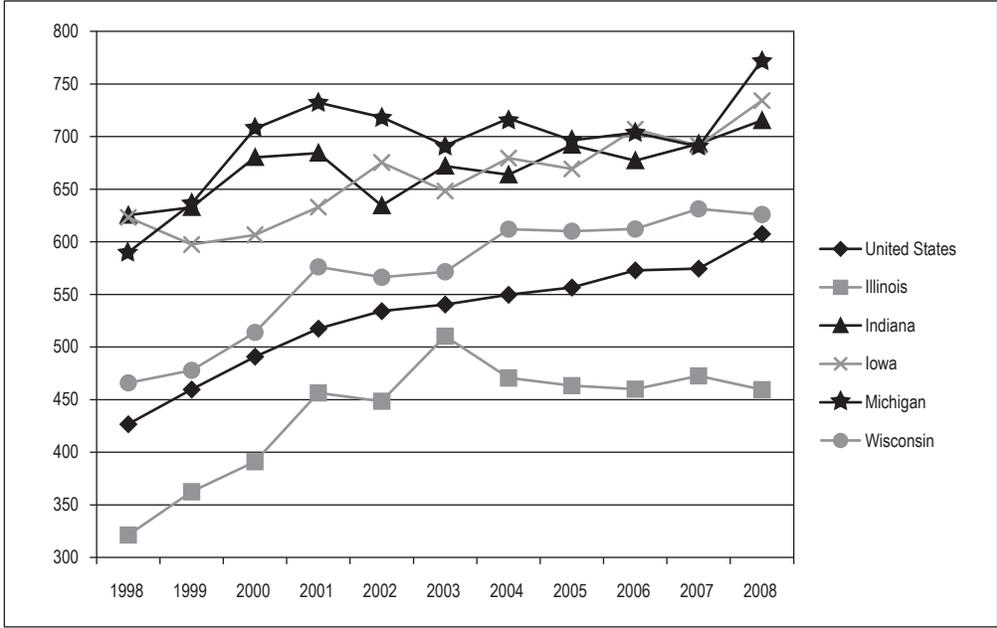
Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

Wisconsin's per capita spending on higher education is about at the U.S. average and less than Michigan, Iowa, and Indiana.

Figure 9 shows per capita spending on higher education. Wisconsin's per capita spending is about at the U.S. average and less than Michigan, Iowa, and Indiana. It is important to note that the U.S. Bureau of the Census includes tuition in Wisconsin's higher education expenditures. The Census definition of state spending on higher education includes all expenditures by state-affiliated universities for core services regardless of the funding source.

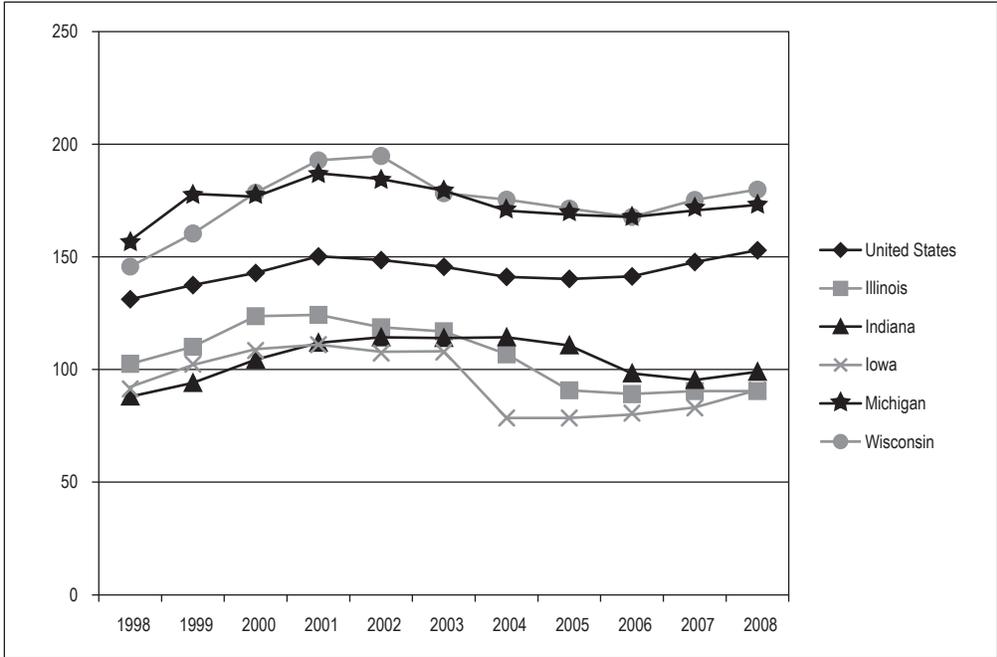
Figure 10 displays per capita expenditures on corrections. Wisconsin's and Michigan's expenditures follow similar trajectories, and both are higher than the U.S. average. Indiana, Iowa, and Illinois have similar expenditures, all lower than the U.S. average. For corrections policy, Wisconsin policymakers often look to Minnesota. Minnesota's per capita expenditures [not shown] are below the U.S. average, similar to Indiana, Iowa, and Illinois.

Figure 9. Higher Education Expenditures—Real 2005 Dollars Per Capita



Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

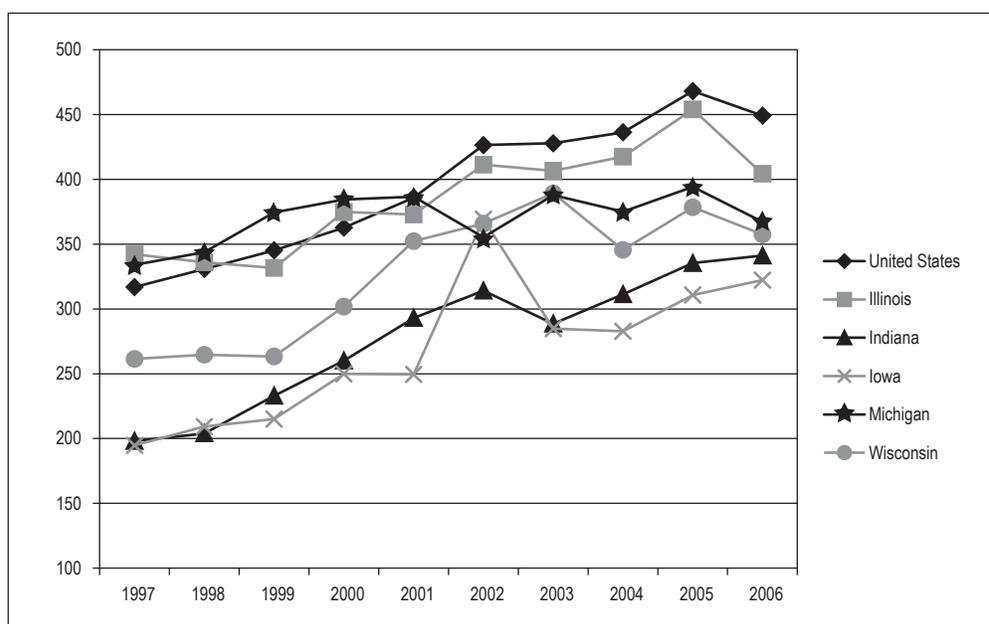
Figure 10. Corrections Expenditures—Real 2005 Dollars Per Capita



Source: U.S. Census Bureau, *State Government Finances*: <http://www.census.gov/govs/state/>; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

Finally, in Figure 11, Medicaid expenditures are reported using data from the Centers for Medicare and Medicaid Services between 1997 and 2006. Wisconsin's Medicaid expenditures are in the middle of the pack, less than Illinois and Michigan, and more than Indiana and Iowa. The cross-state rankings are similar if the cost of the Children's Health Insurance Programs is included. Data on Medicaid expenditures since 2008 are not available by state, so these data do not capture increases in enrollment as people have lost jobs or new people have become eligible because of changes in the program. For example, the 2009 expansion of Wisconsin's BadgerCare Plus made health care available to low-income adults without dependent children who have not had health insurance or access to employer-subsidized health insurance in the previous 12 months. According to a November 2010 assessment by the nonpartisan Wisconsin Legislative Fiscal Bureau, the Medical Assistance Program (Wisconsin's Medicaid program) has a projected shortfall of \$148 million in 2010-11.⁶

Figure 11. Medicaid Expenditures



Source: U.S. Centers for Medicare and Medicaid Services, *Financial Management Report*: http://www.cms.gov/MedicaidBudgetExpendSystem/02_CMS64.asp; population estimates from the U.S. Census Bureau: <http://www.census.gov/popest/estbygeo.html>; inflation adjusted using the *GDP Chain-type Price Index*, U.S. Department of Commerce, Bureau of Economic Analysis: <http://www.gpoaccess.gov/eop/2010/B3.xls>.

Can a State Fiscal Crisis Lead to Long-Term Harm?

State fiscal crises always lead to change. By definition, a fiscal crisis occurs when economic conditions require major policy changes to bring the budget into long-term balance. These major policy changes are often spending cuts, revenue increases, or both. So I ask the question: is this a bad thing?

Some analysts have argued that it is not, because these crises force elected officials to make difficult but necessary choices.⁷ These crises, they argue, lead to the elimination of expenditures for weak programs and the expansion of appropriate

revenue sources. In many cases, they argue, this leads to better policy in the long term. This position, however, is controversial.

Policy choices made under financial and time pressure may be determined by short-term political convenience rather than careful policy analysis. Often, the dominant strategies are across-the-board cuts, early retirement incentives, and patchwork revenue compromises. Choices made during crises may not weigh the relative merits of different programs, may ignore longer-term consequences, or may skip analysis of goals other than budgetary impact. Evidence shows that in the wake of the 2001 recession, states were heavily reliant on increases in narrow-based taxes (e.g., the tobacco tax) rather than broad-based taxes (e.g., income or sales taxes). Economists generally regard broad-based taxes as fairer and more efficient.⁸

The abrupt changes in expenditure or revenue policy that often occur in a fiscal crisis can be disruptive and can increase uncertainty. People come to rely on certain services and those services are eliminated. People or businesses make decisions within a given set of tax rules and those rules change. Fiscal crises present opportunities to make needed policy improvements. Yet the historical record is discouraging. Often policies made under pressure are inefficient and inequitable.

Why Aren't State Fiscal Crises More Often Avoided?

Using the example of the 2001 recession, the states had several years to prepare for a recession that they knew would eventually arrive. Why didn't they save enough to weather the storm?

The National Association of State Budget Officers has tracked total year-end balances nationally and in these five Midwest states. States did make an attempt to accumulate reserves in the 1990s but, in the end, their efforts were insufficient to avoid the need for tax increases or spending cuts. All states increased their reserves from the low point during the economic and revenue boom of the 1990s. By the end of fiscal year 2000, the national average balance was more than 10% of expenditures. In the Midwest, some states had reserves higher than the national average. For example, Indiana's and Michigan's reserves were 15% of their total expenditures and Iowa's were 13%. However, Illinois and Wisconsin were below the national averages with reserves of only 7% of expenditures. Year-end balances declined from 2000 to 2001 and again from 2001 to 2002 in the nation and in all five Midwest states.

Why do states find it so difficult to plot and stick to a smooth fiscal path? The simplest answer is this: despite advances in monetary and fiscal policy, state finances reflect both the good and bad years of the business cycle. In the boom periods, policymakers often find it politically appealing to cut taxes rather than to use available resources to finance rainy day funds.

What Can States Do?

Given this pessimistic prospect for implementing balanced budgets over the business cycle, what policy options are available for stabilizing state budgets?

After the 2001 recession, states were heavily reliant on narrow taxes (e.g., tobacco tax) rather than broad-based taxes (e.g., income or sales taxes), which are fairer and more efficient.

1) Accumulate Surpluses or “Rainy Day Funds” to Balance Out Cyclical Downturns. Great political discipline and precise budgetary administration are required to accumulate funds in advance of economic downturns. Often when the conditions are favorable for saving, the public outcry for tax cuts and more services makes it nearly impossible politically to reserve as much revenue as is necessary to guard against future declines. Yet it remains an important strategy for countering shortfalls in state revenues. Some states, like Iowa in recent years, have reserved a portion of revenue as a buffer against future fiscal shocks. For example, in 2008, Iowa exercised restraint by spending only 99% of its revenue.

2) Distinguish Between Short-Term and Long-Term Revenue Sources. Identify one-time or short-term revenue increases (often called transitory revenue sources) and avoid using them to make long-term expenditure commitments. Several examples exist of states that do and do not achieve this budget strategy.

- Iowa enhanced a long-term revenue source by broadening its sales tax base to include taxing of services.
- A negative example is provided by Illinois which has underfunded its state pension systems for many years by borrowing from future retirees to pay its current bills. Illinois compounded the problem in 2003 by borrowing \$10 billion to increase funding of the pension system, and using \$2 billion of it to ease the short-term budget crisis.
- Commendably, Florida differentiates between recurring and non-recurring revenues and expenditures in its budget process. However, in periods of fiscal stress, non-recurring revenues have been used to fund recurring expenditures.⁹

3) Make and Publish Multi-Year Budget Forecasts. In most states, balanced budget requirements and current fiscal practices focus almost entirely on competing priorities within the next fiscal year’s budget. However, most budgetary decisions have multi-year consequences and the impacts are often uneven over time. There are several reasons to advocate 2, 5, or even 10-year budget forecasts:

- Multi-year forecasting could discipline the tendency to increase spending or cut taxes in the good years of a revenue cycle. Decisions like these make the good years appear better by making future years worse. Short-term decisions do not solve structural budget deficits and tend to turn the inevitable cyclical downturns into fiscal crises.
- Many of the short-term adjustments made to balance the next fiscal year’s budget involve time shifting of expenses or revenues, which worsens budgets in the next biennium. An extreme example involves borrowing against future revenue streams and spending the proceeds

Short-term decisions do not solve structural budget deficits and tend to turn the inevitable cyclical downturns into fiscal crises.

in a single year. In the 2001 crisis, many states did this with tobacco settlement funds.

- Budget forecasts would require acknowledgement of predictable events or policy changes with important impacts on future budgets. Examples include scheduled federal income or estate tax law changes with predictable impacts on state revenue sources.
- Demographic changes have large, but predictable, impacts on state budget expenditures (e.g., education system, long-term care expenditures, state health care and pension costs), and even state revenues. The big event may be five or more years in the future, but current budget choices should plan for the change in order to ease the transition and avoid fiscal crises.

4) Consider the Family Impacts of Decisions, Particularly on the State's Most Vulnerable Children and Families. During recessions, the needs of distressed populations increase as family members lose jobs and often health care. To meet the needs of vulnerable families, states took a number of steps in response to the 2001 recession. Between 1995 and 2003¹⁰:

- Five states (California, Colorado, Iowa, Maryland, and New York) enacted or increased tax credits to offset child care costs.
- Seven states enacted or increased Earned Income Tax Credits (Indiana, Kansas, Maryland, Massachusetts, Minnesota, New York, and Wisconsin).
- Two states enacted or increased low-income housing credits (Massachusetts and Maryland).
- Arizona decreased tax rates, concentrating on lower-income levels, and established a family income tax credit based on family size and income.
- Georgia established a food tax credit.
- New Mexico expanded its low-income comprehensive tax rebate.
- Pennsylvania increased exemptions for low-income families.
- Massachusetts and West Virginia increased their minimum tax thresholds.
- Indiana increased their low-income tax deduction.

Often states will experience decreases in revenue just as they experience increases in eligibility for state services such as unemployment insurance and Medicaid.¹¹ Thus, to provide even the same services available before a recession, states will have to increase spending to account for the larger, newly eligible population. Also, if costs rise from a particular part of the budget (e.g., health care), even level spending may require cuts in services.

There is little evidence that state spending responds to increases in family needs. This suggests that the most vulnerable people in the poorest states may bear the biggest burden during fiscal crises.

The most vulnerable people in the poorest states may bear the biggest burden during fiscal crises.

Summary

Budget strategies that may be effective in the long-run may not pay off right away.

In sum, fiscal crises can result in bad policy decisions. Budget strategies that may be effective in the long-run may not pay off right away. Too often, shortfalls have been covered with short-term cost shifting. Three examples include outright increases in debt, convenient but not necessarily sound strategies for increasing revenue, and unrealistic and unsustainable time shifting of obligations and revenues.

States can minimize the likelihood of these policy mistakes by taking concrete steps to encourage budgets that are balanced over the business cycle rather than in a single year. Some states have put in place strategies for building more sustainable budgets. State policymakers should begin now to establish standards for a rainy day fund sufficient to weather an economic downturn; to distinguish between long-term and transitory revenues; to make and frequently revise long-term budgetary projections; and to consider the family impact of budget decisions, particularly for a state's most vulnerable children and families.

Professor David Merriman is Associate Director of the Institute of Government and Public Affairs and Professor of Public Administration at the University of Illinois at Chicago. He previously spent 20 years on the faculty at Loyola University of Chicago. He is currently directing the "Fiscal Futures Budget Project," a long-term, budget-trend projection model for examining the structural deficit in the Illinois budget. The National Tax Association named his dissertation the most outstanding in government finance and taxation. He was named "Researcher of the Year" at Loyola University in 2002-2003.

This chapter was adapted from the following publications:

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