Evidence-Based Budgeting
Making Decisions to Move Wisconsin Forward
Evidence-Based Budgeting:
Making Decisions to Move Wisconsin Forward

First Edition

Wisconsin Family Impact Seminars
A collaborative of the Center for Excellence in Family Studies
in the UW-Madison School of Human Ecology and UW-Extension/Cooperative Extension

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Purpose and Presenters

In 1993, Wisconsin became one of the first states to conduct Family Impact Seminars modeled after the seminar series for federal policymakers. The Wisconsin Family Impact Seminars provide objective, high-quality research on family issues to promote greater use of evidence in policy decisions and to encourage policymakers to examine the family impacts of policies and programs. Family Impact Seminars highlight the consequences that an issue, policy, or program may have for families. Because of the success of the Wisconsin Family Impact Seminars, the Policy Institute for Family Impact Seminars, established at the University of Wisconsin-Madison/Extension, is now helping 29 states conduct their own Seminars.

The Family Impact Seminars are a series of presentations, discussion sessions, and briefing reports that provide high-quality, solution-oriented research on family issues for state legislators and their aides, Governor’s office staff, legislative service agency staff, and state agency officials. The Seminars provide objective, nonpartisan research and do not lobby for particular policies. Seminar participants discuss policy options and identify common ground where it exists.

“Evidence-Based Budgeting: Making Decisions to Move Wisconsin Forward” is the 29th Wisconsin Family Impact Seminar. For information on other Wisconsin Family Impact Seminar topics or on Seminars in other states, please visit our web site at http://www.familyimpactseminars.org.

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Briefing Reports

Each Family Impact Seminar is accompanied by an in-depth briefing report that summarizes the latest research on the topic and draws implications for families and for state policymakers. Since 1993, 29 seminars have been conducted on topics such as corrections, growing the state economy, Medicaid, prisoner reentry, school funding, and workforce development. For a list of the seminar topics and dates, please visit the Wisconsin Family Impact Seminar web site at http://www.familyimpactseminars.org (enter a portal and click on State Seminars). Each seminar has a page on which you can view the list of speakers, download a briefing report, and listen to the audio of the seminar presentations.

Reports can also be downloaded from the UW Cooperative Extension Publications web site at http://learningstore.uwex.edu. Legislators can request a free bound copy of any report directly from the Wisconsin Family Impact Seminars at (608) 263-2353.

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Executive Summary

In the wake of the worst recession since the Great Depression, Wisconsin policymakers face a substantial budget shortfall. A recovery is underway, but the Wisconsin Department of Revenue (2010) predicts it will take until mid 2013 for the economy to return to pre-recession levels. For states, next year “could be the worst year of this four- or five-year downturn period,” according to Scott Pattison, Director of the National Association of State Budget Officers. What lessons can be learned from this recession to build more sustainable budgets in the future? This briefing report features three national experts discussing how evidence can be used to inform state budget decisions. Wisconsin’s revenues and expenditures are compared with other Midwest states, and strategies are presented for identifying and investing in evidence-based, cost-effective programs that improve outcomes for individuals, children, and families.

In the first chapter, Steve Aos, Director of the nonpartisan Washington State Institute for Public Policy, reviews procedures for making evidence-based and cost-effective budget decisions. At the request of the Washington State Legislature, the Washington State Institute for Public Policy developed procedures for using evidence to maximize return on taxpayer investment for prevention and intervention programs and policies. The return on taxpayer investment has been calculated for a number of policies and programs affecting child maltreatment, crime, education, employment, housing, mental health, public assistance, public health, and substance abuse outcomes. These results detail which programs yield the greatest benefit for the least cost. For interested states, software will soon be available to allow easy access to the Institute’s findings and procedures. With this software, states can replicate these analyses based on their own demographics and program costs.

The second chapter is written by Professor David Merriman, Associate Director of the Institute of Government and Public Affairs at the 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.

The third chapter is written by Professor William Fox, Director of the Center for Business and Economic Research, at the University of Tennessee. The chapter reviews how the recent recession has left in its wake high unemployment rates and tax revenues that are slow to rebound. The biggest challenge facing state policymakers is designing revenue systems that will work beyond the current budget cycle. Revenues should match the spending that is required to maintain the
level of services that a state chooses to deliver without frequent rate adjustments. States have four basic strategies for balancing state budgets: expenditure cuts, federal stimulus money, reliance on reserves, and policy-based revenue enhancements. This chapter outlines which policy options states are implementing to develop more sustainable revenue streams, and what economists say about their effectiveness. The chapter concludes with specific budget lessons of this recession.

The Wisconsin Family Impact Seminars are interested in the fiscal crisis that Wisconsin is facing because of the implications that it has for families and because of the implications families have for the state economy. Families are a key contributor to human capital, which is one driver of a nation’s economic competitiveness.

Throughout this report, family impacts are emphasized: (1) what impact the recession has for families, (2) whether states have responded to family needs, and (3) in what ways some states have responded. First, during recessions, the state’s most vulnerable families are at risk as family members lose jobs and often health care. Just when families face increasing need for state services such as unemployment insurance and Medicaid, states experience decreasing revenue for providing such services. Second, little evidence exists that state spending responds to this increase in family needs. Without such a response, the most vulnerable families may bear the biggest burden during fiscal crises.

Finally, in response to a recession, states often enact policies to enhance revenues in ways that may be regressive or harmful to those families with the fewest resources. Many states have countered this regressivity through policy levers such as providing tax relief to low-income families. As detailed in the Merriman chapter, states have enacted policies to increase the Earned Income Tax Credit, raise the minimum tax threshold, and enact or enhance child care, homestead, and energy tax credits. To determine how to best help families perform the important functions they provide for their members and society, the Aos chapter explains how cost-benefit studies can identify policies and programs that are most effective in achieving a particular outcome, while at the same time providing the greatest return on taxpayer investment.
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Senator Julie Lassa            Representative Gordon Hintz
Senator Mark Miller            Representative Donna Seidel
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Using Evidence to Maximize Return on Taxpayer Investment

by Steve Aos
Director, Washington State Institute for Public Policy

This chapter reviews procedures for making evidence-based and cost-effective budget decisions. At the request of the Washington State Legislature, the nonpartisan Washington State Institute for Public Policy developed procedures for using evidence to maximize return on taxpayer investment for prevention and intervention programs and policies. The return on taxpayer investment has been calculated for a number of policies and programs affecting child maltreatment, crime, education, employment, housing, mental health, public assistance, public health, and substance abuse outcomes. These results detail which programs yield the greatest benefit for the least cost. For interested states, software will soon be available to allow easy access to the Institute’s findings and procedures. With this software, states can replicate these analyses based on their own demographics and program costs.

Are there more effective ways to use taxpayer money to achieve key state outcomes? At the request of the Washington State Legislature, the nonpartisan Washington State Institute for Public Policy has calculated the return on investment for a number of evidence-based prevention and intervention programs and policies.

This chapter summarizes the four-step approach used by the Institute over the last 15 years. Recently, the MacArthur Foundation and the Pew Center on the States have joined with the Washington State Legislature to fund the Institute to summarize what has been learned through the cost/benefit analyses on specific policy issues and how these lessons could be applied more broadly to state budget decisions.

When the project is complete, the Institute will have produced an investment guide—a comprehensive list of the cost effectiveness of programs and policies that improve outcomes for individuals, children, and families. These results and procedures will be made available to interested policymakers through user-friendly software.

What is Washington State’s Experience with Evidence-Based Budgeting?

For the last 15 years, the Washington State Legislature has requested evidence-based and cost-beneficial data on several issues:

- child maltreatment,
- crime,
- employment,
- housing,
- K–12 education,
- mental health,

The Institute is producing an investment guide of cost-effective programs and policies that improve outcomes for individuals, children, and families.
• public assistance,
• public health, and
• substance abuse.²⁻⁶

These requests have raised two fundamental policy questions of interest to policymakers:

1) How can state government better achieve particular public outcomes, while providing citizens with a superior return on their tax dollars?

2) Can the legislature use “evidence” and “costs and benefits” to help craft strategic public policies that lead to measurable improvements in key statewide outcomes?

The Washington State Institute for Public Policy has developed procedures to respond to these questions and to maximize return on taxpayer investment. For example, the Legislature asked the Institute to identify evidence-based public policies shown to improve high school graduation rates. The rate of students in Washington State who graduate on time has not increased for several decades.⁷ Thus, the project will examine:

• What evidence-based public policies could lead to improved high school graduation rates in Washington?
• Which of these public policies can also pass an economic test producing benefits that exceed costs?
• If Washington adopted a combination of the best policies, how could policymakers expect the state’s high school graduation rate to change over the next decade?
• What are the measurable benefits to Washington’s economy, and how could taxpayer costs of other public services, such as prisons or health care, be reduced if graduation rates increase?

The purpose of this project is to address these types of questions for the array of public outcomes listed above. The Washington State Legislature can then use the results to make funding decisions. For example, in the past, the Legislature has altered funding priorities to invest heavily in programs and policies shown to be cost-effective.

How Does the Research and Analysis Work?

Over the last decade, we at the Institute have developed and improved a consistent four-step analytical process:

1) We assess evidence on what works.
2) We calculate costs and benefits for Washington and produce a Consumer Reports-like list of public policy options.
3) We provide a “portfolio-level” analysis to look beyond a single study to examine how a set of policy options affects statewide outcomes of interest.
4) We measure the riskiness in our conclusions by testing how bottom lines vary when assumptions of the study are changed.

Based on cost-benefit studies, the Washington State Legislature has altered funding priorities to invest heavily in programs and policies shown to be cost-effective.
Each of these steps is described below:

**Step 1: Review of the Research Evidence on What Works (and What Does Not).** For each of the topics we study, we begin by carefully analyzing all high-quality research from anywhere in the United States and abroad to determine which options have best achieved desired outcomes (and which ones have not). We look for research studies with strong, credible evaluation designs and we discard studies with weak designs.

The goal of this stage of the analysis is to estimate an expected effect of “actionable” public policies. By “actionable,” we mean the identification of specific kinds of decisions that state legislators can or do make when they craft legislation. We then systematically assess the entire research literature on a given topic using a process called meta-analysis. Instead of just reporting the results of one or two favorite studies, a competently done meta-analysis reviews all the credible studies on a topic, and carefully screens and adjusts the size of the effects depending upon the rigor of the research and other factors. Based on credible evidence, this process produces an average expected effect, as well as a measure of uncertainty.

**Step 2: Compute the Economics (Costs and Benefits) of Specific Policy Options.** After Step 1, we estimate the average effect of a policy or program. We then insert costs and benefits into the analysis by answering two further questions: (1) How much does it cost to produce the effect found in Step 1, and (2) How much is it worth to people in Washington to achieve the outcome?

We summarize the economic findings by reporting standard financial statistics: net present values, benefit-cost ratios, and return on investment. We also present the estimates from three distinct perspectives: the benefits that accrue directly to program participants; the benefits received by taxpayers; and the benefits to non-participants and non-taxpayers that don’t fall into the other two categories. The addition of these three perspectives provides a “total state” bottom line.

For example, an early childhood education program may directly benefit the participant by increasing his or her lifetime economic earnings. It may also directly benefit taxpayers in two ways: some of these earnings will be taxed and other program benefits, such as reduced crime, will lower taxpayer costs of the criminal justice system. Finally, the program may achieve benefits for non-participants in other ways, such as reducing the costs of being a crime victim. Adding these three perspectives produces a total state perspective. We have found that it is useful in the public policy process to provide information for all three perspectives. Each can help answer specific questions that arise when legislators are considering particular policy options.

**Step 3: Analyze “Portfolio-Level” Effects.** The main products of Steps 1 and 2 are Consumer Reports-like lists of what works and what does not. We rank specific policy options according to estimates of those that provide the greatest benefit for the least cost. That information has proven to be helpful to Washington legislators as they make decisions. What is even more helpful, we have found, is to estimate how a set of adopted policies are likely to achieve broad public policy goals. In this

**We rank specific policy options according to estimates of those that provide the greatest benefit for the least cost.**
third analytic step, we move beyond estimates of individual programs and policies; instead, we estimate the degree to which a portfolio of adopted policies is likely to affect measurable statewide outcomes.

For example, in the 2007 session, the Legislature began to use the Institute’s estimates and invested in a portfolio of evidence-based and economically sound prevention, juvenile justice, and adult corrections programs. These programs are expected to reduce Washington State’s crime rate, the need to build additional prisons, and criminal justice spending by state and local municipalities. In effect, the Washington Legislature placed a fiscal bet that these evidence-based programs will deliver better results for the taxpayers who are footing the bill.

**Step 4: Conduct Uncertainty Analysis to Assess the Riskiness of the Bottom-Line Estimates.** Our final analytical step involves testing the robustness of our results. Single-point bottom lines offer a convenient finding. Yet a considerable amount of uncertainty can exist in any estimates of benefits and costs, so it is important to see how conclusions change when assumptions are altered. This type of risk and uncertainty analysis is commonly used by many businesses in private sector decision making. We use the same tools to test the riskiness of the public sector options we have been assigned to study.

To do this, we perform an analysis to determine the probability that our estimates would produce a contrary finding—that is, that money would be lost rather than gained if a particular policy were adopted. Thus, this analysis produces two bottom-line statistics: an expected value of overall benefits minus costs, and an estimate of the risk that a given strategy could produce negative net benefits.

**What Resources are Available on Evidence-Based Budgeting?**

Because of its success in Washington, we have been asked to develop user-friendly software that will allow easy access to the Institute’s findings and procedures. Other interested states can use this software to adapt Washington’s approach to their own state. With this tool, states can replicate these analyses based on their own demographics and program costs. State-specific benefits to taxpayers can be calculated for different portfolios of policy options. A final report on the project is expected in June 2011.

**Conclusion**

The Washington State Legislature requested investment advice on how to better use taxpayer money to achieve key public outcomes. In response, procedures for making evidence-based and cost-effective budget decisions were developed by the Washington State Institute for Public Policy. This project offers an investment guide that details which programs provide the most benefit at the least cost. This comprehensive list of programs and policies that improve outcomes for individuals, children, and families in Washington can result in a more cost-efficient use of public resources. Soon software will be released that allows interested policymakers to replicate these analyses in ways that are tailored to a state’s demographics and program costs.
Mr. Steve Aos is the Director of the Washington State Institute for Public Policy, a nonpartisan research arm of the Washington State Legislature. He has 34 years of experience conducting cost-benefit analyses and communicating the results to policymakers and the private sector. His cost/benefit studies cover a wide range of public policies including crime, K–12 education, substance use, and child abuse/neglect. In fact, one of his earlier analyses has been downloaded 32,000 times. He is currently leading a project funded by the MacArthur Foundation and the Pew Center on the States on advancing the use of evidence and economics in state policymaking.

This chapter was adapted from the following publication:


Endnotes


Actionable Public Policies
The identification of specific kinds of decisions that state legislators can or do make when they craft legislation.

Benefit-Cost Ratio
An economic indicator of cost-effectiveness, computed by dividing present value benefits by present value costs, which indicates the amount of benefits returned for each dollar invested.¹

Cost-Benefit Analysis (or Benefit-Cost Analysis)
A technique used to compare the total expected costs associated with an investment to the benefits that it proposes to return. Both tangible and intangible factors should be addressed and accounted for in costs and benefits.²

Evidence-Based
Refers to intervention and treatment approaches that have been shown effective through research and evaluation studies that meet established standards of scientific rigor.³

Meta-Analysis
A process by which findings from several individual studies that address a common problem are statistically integrated and analyzed to determine an average effect size for a treatment or intervention.⁴

Net Present Value
The result of subtracting the total present value of costs from the total present value of benefits to obtain a net benefit or cost. All future benefits or costs are first converted into current or “present” dollar values.⁵

Uncertainty Analysis (or Sensitivity Analysis)
A technique of assessing the extent to which changes in assumptions or input variables will affect the ranking of alternatives.⁶

Glossary Endnotes
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.

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**

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<tr>
<td>United States</td>
<td>100%</td>
<td>51.6%</td>
<td>18.4%</td>
<td>3.4%</td>
<td>15.9%</td>
<td>29.5%</td>
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<tr>
<td>Illinois</td>
<td>100%</td>
<td>57.7%</td>
<td>18.7%</td>
<td>5.6%</td>
<td>14.4%</td>
<td>26.7%</td>
</tr>
<tr>
<td>Indiana</td>
<td>100%</td>
<td>51.7%</td>
<td>16.5%</td>
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<td>Iowa</td>
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<td>Michigan</td>
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<td>14.6%</td>
<td>3.6%</td>
<td>16.7%</td>
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<tr>
<td>Wisconsin</td>
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<td>25.1%</td>
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**Table 1B. Relative Importance of Selected State Budget Categories—Percent of Total General Revenue**

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<td>United States</td>
<td>99.2%</td>
<td>20.4%</td>
<td>13.0%</td>
<td>3.3%</td>
<td>9.8%</td>
</tr>
<tr>
<td>Illinois</td>
<td>98.3%</td>
<td>15.4%</td>
<td>11.4%</td>
<td>2.3%</td>
<td>10.6%</td>
</tr>
<tr>
<td>Indiana</td>
<td>97.2%</td>
<td>16.7%</td>
<td>16.7%</td>
<td>2.3%</td>
<td>7.4%</td>
</tr>
<tr>
<td>Iowa</td>
<td>98.8%</td>
<td>20.2%</td>
<td>15.7%</td>
<td>1.9%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Michigan</td>
<td>101.4%</td>
<td>25.9%</td>
<td>16.9%</td>
<td>3.8%</td>
<td>8.2%</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>100.1%</td>
<td>21.5%</td>
<td>13.5%</td>
<td>3.9%</td>
<td>7.9%</td>
</tr>
</tbody>
</table>

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.

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

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>United States</td>
<td>2.30%</td>
<td>1.68%</td>
<td>2.19%</td>
<td>1.59%</td>
<td>1.03%</td>
<td>2.88%</td>
</tr>
<tr>
<td>Illinois</td>
<td>2.15%</td>
<td>2.01%</td>
<td>1.11%</td>
<td>1.85%</td>
<td>0.70%</td>
<td>2.21%</td>
</tr>
<tr>
<td>Indiana</td>
<td>2.43%</td>
<td>1.44%</td>
<td>-1.21%</td>
<td>-3.12%</td>
<td>3.06%</td>
<td>4.64%</td>
</tr>
<tr>
<td>Iowa</td>
<td>2.72%</td>
<td>0.98%</td>
<td>1.76%</td>
<td>3.09%</td>
<td>-0.77%</td>
<td>4.85%</td>
</tr>
<tr>
<td>Michigan</td>
<td>0.56%</td>
<td>-0.97%</td>
<td>-1.24%</td>
<td>-5.20%</td>
<td>-1.69%</td>
<td>1.94%</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>1.39%</td>
<td>0.09%</td>
<td>-0.20%</td>
<td>-0.56%</td>
<td>0.43%</td>
<td>3.25%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>2.67%</td>
<td>2.54%</td>
<td>3.59%</td>
<td>1.55%</td>
<td>3.55%</td>
<td>1.00%</td>
</tr>
<tr>
<td>Illinois</td>
<td>2.52%</td>
<td>1.61%</td>
<td>3.64%</td>
<td>-1.25%</td>
<td>1.68%</td>
<td>0.47%</td>
</tr>
<tr>
<td>Indiana</td>
<td>2.64%</td>
<td>1.12%</td>
<td>1.35%</td>
<td>1.18%</td>
<td>5.59%</td>
<td>0.63%</td>
</tr>
<tr>
<td>Iowa</td>
<td>2.35%</td>
<td>2.16%</td>
<td>1.65%</td>
<td>-0.15%</td>
<td>5.16%</td>
<td>0.30%</td>
</tr>
<tr>
<td>Michigan</td>
<td>1.28%</td>
<td>-0.04%</td>
<td>2.73%</td>
<td>0.96%</td>
<td>0.95%</td>
<td>0.20%</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>2.08%</td>
<td>0.81%</td>
<td>3.00%</td>
<td>2.13%</td>
<td>3.18%</td>
<td>0.61%</td>
</tr>
</tbody>
</table>


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


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. 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**

![Graph showing real per capita state general revenue over time and across states.](image)

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, Iowa, 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**

![Figure 2. State Total Tax Revenue—Real 2005 Dollars Per Capita](source)

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 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’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.
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

![General Sales Tax Revenue Chart]


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. 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


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

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

![Graph showing per capita real 2005 dollars spent on elementary and secondary education from 1998 to 2008 for the United States, Illinois, Indiana, Iowa, Michigan, and Wisconsin.](image)


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


Figure 10. Corrections Expenditures—Real 2005 Dollars Per Capita

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

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?
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.³

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.
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 2003:

- 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. 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.
Summary

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:


Endnotes

1, 3, 4Reinhardt, R., & Swain, S. (2011). State and local government revenue (Informational Paper #74). Wisconsin Legislative Fiscal Bureau, Madison, WI.


Designing Revenue Policy for Wisconsin’s Future

by William Fox
Director, Center for Business and Economic Research
Professor, Department of Economics, University of Tennessee, Knoxville

The recent recession has left in its wake high unemployment rates and tax revenues that are slow to rebound. The biggest challenge facing state policymakers is designing revenue systems that will work beyond the current budget cycle. Revenues should match the spending that is required to maintain the level of services that a state chooses to deliver without frequent rate adjustments. States have four basic strategies for balancing state budgets: expenditure cuts, federal stimulus money, reliance on reserves, and policy-based revenue enhancements. This chapter outlines which policy options states are implementing to develop more sustainable revenue streams and what economists say about their effectiveness. The chapter concludes with specific budget lessons of this recession.

Economists often evaluate tax systems according to their fairness, economic effects, revenues, administrative costs, and political and legal constraints. Each characteristic is important. However, the biggest challenge facing state policymakers is designing revenue systems that will work beyond the current budget cycle. States may differ in their decision on the appropriate size of government. Tax policy should be designed to generate sufficient revenue to finance the preferred size of government without the need for frequent rate adjustments.

This chapter begins by describing the unique situation of state governments, including what constitutes sufficient revenue and appropriate spending growth. I then describe the effect of the recent recession on states and the strategies states are currently using to address budget shortfalls. I conclude with budget lessons that state policymakers have learned through our recent recession experience.

Sufficient Revenue and Government Spending

One goal of state tax policy should be generating sufficient revenue—revenue that is sufficient in the current year and also in the years to come. The services that government funds typically do not begin and end with a state’s fiscal calendar. So, fiscal crises are typically not the outcome of a single year of difficulties; they are more often the result of an accumulation of problems over a number of years. Thus, sufficient revenue exists when revenue growth matches the growth in spending that is required to maintain the level of services a state chooses to deliver.

No simple answer exists as to the question of how fast government spending should be expected to rise. An easy answer is that revenues should rise at approximately the same rate as the economy. This means that state government would stay a constant share of the economy unless an explicit decision is made to decrease or increase the size of government. One state, Colorado, through the Taxpayer Bill of Rights (TABOR), has chosen to limit spending from revenue growth to no faster
than the combination of inflation plus population change. Choosing an appropriate inflation rate for state government is problematic; for example, state budgets are disproportionately affected by rising health care costs given their expenditures for Medicaid, employee fringe benefits, and so forth.

In the long run, a simple formula like that of TABOR will result in a decrease in a state’s ability to deliver services. Consider the case in which K-12 education rises as the sum of these two factors (inflation plus population change). Teachers would be able to receive a raise equal to the rate of inflation, and schools would be able to continue buying the same items each year. However, teachers would receive raises that are lower than the average in the private sector, because private sector raises are approximately equal to inflation plus productivity gains. Over time, as relative wages fall, the quality of people who choose careers in education and who stay in education will decline; ultimately, the quality of education will drop. Thus, to keep the quality of education constant, education expenditures must rise faster than inflation plus population change.

Similar arguments can be made for many other public services. Government spending should rise at a rate that is unique from the private sector, taking into account the specific services that states fund.

The Recession’s Effect on State Revenue

In the search for good tax policy, every state must begin with the realities of the recent recession. State economies were not impacted evenly by the recession, but every state felt its effects. The private sector in every state experienced employment losses, and the overall economy has fallen in nearly every state during the past year. Overall, the U.S. economy lost 8.4 million jobs during the recession, including declines in nearly every industry except health care. The private sector experienced almost all of the job losses. Job losses have stopped, but it will take several years to replace all of the lost jobs; moreover, some industries, such as housing construction, will not return to their former peaks. The economy has added back about 0.9 million jobs during the past 10 months.

Experience of the past two recessions suggests that state tax revenue is becoming increasingly variable. Tax revenue in the states fell by 8.2% on average during the 2009 fiscal year; personal income taxes declined by 13.6%, the greatest loss among the major taxes. Corporate income declined by 10.9%, and sales tax revenue declined by 4.8%.

Tax revenues will likely bounce back more slowly than the economy; in fact, tax revenues in many states will have started growing again by the 2011 fiscal year, but revenues will not reach the peaks attained in the 2008 fiscal year until 2012 or 2013. It will be even longer before tax revenues return to their earlier share of the economy.
Strategies for Financing Revenue Shortfalls

In the midst of these shortfalls, states are using some combination of four strategies for balancing their budgets: expenditure cuts, federal stimulus money, reserves, and policy-based revenue enhancements.

1) **Expenditure cuts.** In general, expenditure cuts are being used by states at levels not seen in recent history. Actual cuts occurred in 2009 and are expected again in 2010 for the first time since 1983, when very small cuts were enacted. For example, in 2009, 30 states reported making targeted expenditure cuts, 20 reduced aid to local governments, 17 laid off employees, and 15 instituted furloughs. Many states will need to make additional cuts in the 2011 fiscal year.

2) **Federal stimulus money.** During 2009 and 2010, an estimated $560 billion will be spent (including tax cuts) as part of the federal American Recovery and Reinvestment Act. More than one-fourth of the funds are transfers to states; moreover, an additional one-seventh is infrastructure spending, some of which will also go to states. States have varying degrees of flexibility in spending the money, but it has clearly lessened the effects of declining revenues on state budgets. Still, the stimulus money was not sufficient to prevent the need for spending cuts. Most of the transfers to states will be spent by the end of the 2011 fiscal year. As a result, most states will have fewer resources in the 2012 fiscal year, forcing additional spending reductions.

3) **Reserves.** Most states had rainy day funds and other reserves as the recession began. Use of reserves to lessen the impact of falling revenues can be good policy if implemented appropriately. However, reserves should be thought of as one-time funds, whereas the fiscal problems associated with the recession will last at least five years. States would have needed reserves of more than 30% of their revenues to maintain expenditure patterns in the face of such significant revenue losses. So reserves cannot be seen as the only solution; they can only be used to prevent the most extreme cuts or to allow the state’s books to be balanced.

4) **Policy-based revenue enhancements.** In 2010, tax rate hikes and other policy-related revenue enhancements are expected to cause the largest policy increase in revenues in recent history. For example, at least 10 states raised their sales tax rates and 10 states boosted their income tax rates in 2009 and 2010. In fact, until these recent rate increases, there had been a strong decreasing trend in income tax rates since the mid-1980s (and 5 still cut their income tax rates in 2009 and 2010). In contrast, sales tax rates have been rising continuously for decades, to offset the effects of a shrinking tax base. The median state rate was 3.25% in 1970 and has now reached 6%. The tax that grows faster relative to the economy is the individual income tax, which can offset slower growth of other revenue sources. Income tax grows along with the economy in the long term, although it has been more variable in the short term. Few additional rate increases can be expected during the next year given the current political environment, which will place more pressure on expenditure cuts.
Policy Options to Build More Sustainable Revenue Systems

If you ask economists for advice on good revenue policy, here is the consensus: Select the appropriate revenue sources, structure them correctly, and put the necessary weight on each source. Below we consider which steps states have taken to develop more sustainable revenue streams and what economists say about their effectiveness.

Arizona, Arkansas, Iowa, Missouri, Nevada, New Mexico, New York, North Dakota, South Carolina, and Vermont allow relatively broad tax exemptions for sales by not-for-profit entities, and many more allow exemptions for purchases by not-for-profit entities. Economists believe that sales by nonprofits should generally be taxable. Most states do not explicitly require that nonprofits be in the public interest, yet they still permit the exemption. The exemption is sometimes seen as a subsidy to the nonprofit but, if so, the subsidy is poorly targeted and likely more expensive than a direct subsidy. If nonprofits are treated like businesses, their purchases often should be exempt since they represent inputs for production.

Washington, Florida, and Tennessee raise over 60% of revenues from the sales tax. South Dakota, Texas, and Arizona raise over 50% of their revenues from the sales tax. Since 2009, at least 10 states have increased sales tax rates. Overall, 45 states levy a general sales tax with the average state raising 31.9% of its tax revenue in this way. In Wisconsin, 28.2% of revenues derive from the sales tax.

Economists offer two pieces of policy advice if sales tax is to be good for economic growth and economic efficiency. First, sales taxes should be levied at low, flat rates on the broadest possible base of consumption. That is, instead of increasing tax rates, it is better to expand the base. In studies, a broad base did not reduce the size of the state’s economy. Also, a broad base does not steer consumer behavior because it provides a small set of choices between exempt and taxable items. Taxing all consumption goods generally eases compliance and administrative burdens. However, in most states, the base is too narrow. Exemptions exist for many services and an increasing number of consumer goods (e.g., food for consumption at home, some clothing, etc.).

Second, intermediate transactions, or business input purchases for the purpose of creating “product,” should be exempt from sales taxation. The first piece of policy advice, that taxes apply broadly to sales, does not apply to business-to-business transactions. This is the case because businesses produce; they do not consume. Essentially all states already exempt goods that become component parts of manufactured goods, and exempt goods purchased for resale, along with a number of other specified purchases. Extending exemptions to all business purchases, however, would likely lead to widespread evasion.

Additionally, policymakers must be aware of how hard it is to comply with a piecemeal approach to sales taxation. When there are multiple exemptions, bases, and tax rates, it is difficult for businesses to comply and also for government to administer.
Unfortunately, economists are hard pressed to find states that follow these combined rules. A few states, such as Hawaii and New Mexico, tax consumer purchases broadly, but those states continue to tax many business-to-business transactions.

**Texas** expanded its taxation of services in the 1990s. **Hawaii and New Mexico** tax medical services. The economy is rapidly shifting from a goods to a service society. However, services are much less likely to be taxed than goods. Health care, construction services, and some other professional services offer the greatest potential for additional revenue. Services that most economists think should not be taxed include intermediate inputs (e.g., legal and accounting services) that are largely purchased by businesses. The number of services that each state taxes can be found at http://www.taxadmin.org/fta/pub/services/btn/0708.html#table.\(^7\) Administrative and compliance costs will likely rise as more services are taxed.

**Hawaii** taxes service on a destination basis. Research on cross border shopping indicates that states can expect some buyers to take advantage of state tax differences, at least along the border; however, these effects are likely to be small. Administering sales taxes on a destination basis is a better solution. Destination taxation, or collection of sales tax at the “destination” of the sale rather than the “origin,” eliminates the potential for revenue competition between governments.\(^8\) Consumers can only avoid tax by not purchasing taxable items, not by purchasing out-of-state. However, destination taxation can increase compliance and administrative costs.

**Most states** have taken some action to broaden, rather than narrow, the sales tax base. **Nebraska,** for example, added 27 services in 2002. Still, the tax base of all states has narrowed over the past decade.

Essentially every state except Hawaii started with narrow sales tax bases and have further disregarded good tax advice—they have narrowed the tax base even more. For example, all states with a sales tax (except Illinois) have exempted prescription drugs. Moreover, there are now 12 states that exempt at least some nonprescription drugs and one imposes a lower rate on nonprescription drugs.\(^9\) Several states have enacted tax holidays on such items as clothing, computers, and school supplies.

Wisconsin provides another example of narrowing the tax base. Prior to 2008, Wisconsin limited the amount of Social Security benefits that were taxable to 50%; after 2008, a new law stipulated that 85% of Social Security benefits are exempt. The financial impact of this decision was an estimated $148 million decrease in state revenue.\(^10\)

Where feasible, states could broaden their sales tax base by including some previously exempt items. Food, clothing, and motor fuels are obvious examples. Food is usually exempted from sales tax because it is considered to be regressive, that is, harmful to those with fewer resources. Many states have countered regressivity through policy levers such as providing tax relief to low-income
designing revenue policy for Wisconsin's future

States can counter regressive taxes by providing tax relief to low-income families (e.g., Earned Income Tax Credits; raising of the minimum tax threshold; and child care, energy, and homestead tax credits).

For example, a number of states across the country have enacted policies to increase the Earned Income Tax Credit, raise the minimum tax threshold, and enact or enhance child care, homestead, and energy tax credits. According to economists, policies such as these to protect vulnerable families would be more efficient than broad exemptions that are poorly targeted.11

Table 1 lists the current sales and use tax exemptions in Wisconsin that have fiscal effects of $90 million or greater:

Table 1. Sales and Use Tax Exemptions in Wisconsin Greater than $90 Million

<table>
<thead>
<tr>
<th>Sales and Use Tax Exemptions</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fuel and Electricity Used in Manufacturing</td>
<td>$90,500,000</td>
</tr>
<tr>
<td>Trade-Ins and Lemon Law Refunds</td>
<td>$113,000,000</td>
</tr>
<tr>
<td>Fuel and Electricity for Residential Use</td>
<td>$154,500,000</td>
</tr>
<tr>
<td>Religious, Charitable, Scientific, and Educational Organizations</td>
<td>$156,000,000</td>
</tr>
<tr>
<td>Prescription Drugs and Medicines (Excluding Insulin)</td>
<td>$157,200,000</td>
</tr>
<tr>
<td>Personal Property and Supplies Used in Farming</td>
<td>$158,000,000</td>
</tr>
<tr>
<td>Machinery and Equipment Used in Manufacturing</td>
<td>$173,000,000</td>
</tr>
<tr>
<td>Sales to State and Local Governments and Schools</td>
<td>$340,000,000</td>
</tr>
<tr>
<td>Motor Fuels</td>
<td>$577,000,000</td>
</tr>
<tr>
<td>Food, Food Products, and Beverages (sold primarily to households)</td>
<td>$698,000,000</td>
</tr>
<tr>
<td>Labor Input into Construction</td>
<td>$695,000,000</td>
</tr>
</tbody>
</table>

Delaware, Michigan, Ohio, Texas, and Washington use various types of gross receipts taxes. States have implemented gross receipts taxes for several reasons. For example, the rates are very low compared with those levied on corporate profits. Texas levied a .5% rate and Ohio imposed a .26% rate. They are also more difficult to avoid. Firms are unlikely to choose not to sell in a state merely to avoid a tax rate this low. To the contrary, however, firms do alter their measured profits by changing their corporate structure, moving production to low-tax states, and so forth.12

Kentucky, Pennsylvania, and other states are looking for ways to expand gambling. Gambling has remained a near constant source of total state tax revenues for some years—between 2.1% and 2.5%. Evidence suggests that lotteries result in higher levels of public expenditures than other voluntary revenue mechanisms.13

Several states and the District of Columbia have significantly increased alcohol and cigarette tax rates since 2000. Cigarette tax rates have increased at least 100 times since 2000. Alcohol tax rates have also risen, but to a much lesser extent than tobacco products; alcohol taxes raise only 26% of the combined revenues of alcohol and tobacco. Cigarette tax rates vary considerably across state lines. As a result, between 13% and 25% of consumers purchase cigarettes in lower-tax states or Native American reservations.14 So higher-tax rates in a home state may not...
decrease consumption and may have little effect on tax revenue. The growth of these taxes is expected to be slow because each depends on the quantity consumed.

**States could tax remote transactions.** Expanded taxation of remote transactions is a key to enhanced sales tax efficiency. The shrinking tax base and incentives to buy out-of-state cannot be eliminated until the tax is enforced on a destination basis; this can only happen with vendor collection of the tax. Creating a collection responsibility for all vendors will rely on federal congressional or judicial action as well as interstate and likely international cooperation.

### Budget Lessons Learned

As state policymakers design revenue policies and create effective fiscal strategies for the future, they will be served well to remember the specific budget lessons of this recession:

- Much larger revenue declines are possible than previously expected. Fiscal policy can be designed to lessen, but not eliminate, this possibility.

- Tax structures should be designed to provide sufficient revenue across the business cycle, not just on a biennium-to-biennium basis. This requires states to build reserves during the expansion years, not just reduce tax rates and narrow tax bases.

- States can avoid building new programs and growing expenditures rapidly during expansion years. Instead, they could design a size of government that is consistent with the demands for public services and the revenues that will be available over the long term.

- It is particularly important to ensure that all costs—including pension funds, debt service, and others—are properly funded during expansion years.

- Despite the political difficulty, states should build reserves that are much greater than 10% of revenue. Plans can be made in advance to ensure efficient and appropriate expenditures from the reserves.

**Professor William Fox is a Stokely Distinguished Professor of Business and Professor of Economics at the University of Tennessee, Knoxville. His B.A. is from Miami University and his Ph.D. is from The Ohio State University. Professor Fox has served as a consultant on finance, taxation, and economic development in several states including Louisiana, Minnesota, Missouri, Pennsylvania, and South Carolina. He also has worked with Tax Commissions in Arizona, Hawaii, Kentucky, Minnesota, Ohio, Virginia, and Washington, DC. In addition, he has consulted with multi-national organizations such as the World Bank in creating and revamping tax structures for foreign governments including Rwanda, Egypt, and Jordan. He has received a number of prestigious awards including recognitions from his university, the Institute for Professionals in Taxation, and the prestigious Steven Gold Award (from the National Tax Association, the American Association of Policy Analysis and Management, and the National Conference of State Legislatures).**
This chapter was adapted from the following publications:


Endnotes


Glossary

Compiled by Stephanie Eddy
Consultant, Wisconsin Family Impact Seminars

**Destination Tax (or Destination-Based Sales Tax)**

Retailers collect sales tax based on the destination of a shipment or delivery, rather than its origin. Consumers can only avoid the tax by not purchasing taxable items, not by purchasing out-of-state.
Gross Receipts Taxation
Taxing of businesses based on the total amount of money or other benefit received from all sales activities.\(^2\)

Intermediate Goods/Inputs/Transactions
These terms all refer to transactions in which businesses purchase goods or services for use in production. Because businesses primarily produce, rather than consume, most economists believe these purchases should not be taxed.\(^3\)

Regressive Tax or Regressivity
“A tax that takes a larger percentage of income from low-income groups than from high-income groups.”\(^4\) The opposite of a regressive tax is a progressive tax where the effective tax rate increases as income increases. A proportional tax has an effective tax rate that is fixed so that it takes the same percentage of income from everyone regardless of how much they earn.

Sufficient Revenue
Revenue that is sufficient in the current year and also in the years to come.

Use Tax
An excise tax that may be levied on purchases made from out-of-state or Internet sellers. Use tax is similar to the sales tax paid on purchases made within a state.\(^5\) Goods may be subject to sales or use tax, but not both. “Thus, use tax compensates when sales tax has not been paid.”\(^6\)

Glossary Endnotes


Selected Resources on Evidence-Based Budgeting

For further information, we list selected resources below. For each organization we provide a primary contact person, and relevant reports from the organization when available.

Wisconsin Legislative Service Agencies

Wisconsin Legislative Audit Bureau
22 East Mifflin Street, Suite 500
Madison, WI 53703
(608) 266-2818
http://www.legis.wisconsin.gov/lab/

Contact: Janice Mueller, State Auditor
janice.mueller@legis.wisconsin.gov

Interests: Auditing; financial management; program evaluation; best practices; fraud; policy analysis


Wisconsin Legislative Council
1 E. Main Street, Suite 401
Madison, WI 53703
(608) 266-1304
http://legis.wisconsin.gov/lc/

Contact: Scott Grosz, Staff Attorney
scott.grosz@legis.wisconsin.gov

Interests: Taxation; economic development

Wisconsin Legislative Fiscal Bureau
1 East Main Street, Suite 301
Madison, WI 53703
(608) 266-3847
http://www.legis.wisconsin.gov/lfb/

Contact: Bob Lang, Director
Bob.Lang@legis.wisconsin.gov

Interests: State budget; revenue and appropriations


State economic development programs administered by the Department of Commerce (Informational Paper 92, January 2009). Available at http://www.legis.state.wi.us/lfb/Informationalpapers/92_state%20economic%20development%20programs%20administered%20by%20the%20department%20of%20commerce.pdf

State Agencies

Wisconsin Department of Administration
Division of Executive Budget and Finance
101 E. Wilson Street
Madison, WI 53703
http://doa.wi.gov/

Contact: David Schmiedicke, State Budget Director
(608) 266-1035
david.schmiedicke@doa.state.wi.us

Interests: State budget and finance; capital finance


Wisconsin Department of Revenue
2135 Rimrock Road
P.O. Box 8933, Mail Stop 624-A
Madison, WI 53708
(608) 266-6466
http://www.revenue.wi.gov/index.html

Contact: Office of the Secretary


Universities

La Follette School of Public Affairs, University of Wisconsin-Madison
1225 Observatory Drive
Madison, WI 53706
(608) 262-3581
http://www.lafollette.wisc.edu/welcome.html

Contact: Andrew Reschovsky, Professor of Public Affairs and Applied Economics
(608) 263-0447
reschovsky@lafollette.wisc.edu

Interests: State and local public finance; school funding reform; tax policy; property taxation


Contact: David Weimer, Professor of Public Affairs
(608) 263-2325
weimer@lafollette.wisc.edu

Interests: Cost-benefit analysis


University of Wisconsin/University of Wisconsin-Extension

Contact: Gary Green, Professor and Community Development Specialist
Department of Community and Environmental Sociology
Center for Community and Economic Development
1450 Linden Drive
Madison, WI 53706
(608) 262-2710
ggre@wisc.edu
http://www.uwex.edu/ces/ced/

Interests: Community and economic development; workforce development
Contact: J. Michael Collins, Faculty Director
Department of Consumer Science
Center for Financial Security
1305 Linden Drive, 360 Middleton Bldg.
7401 Social Science, 1180 Observatory Drive
Madison, WI 53706
(608) 262-0369
jmcollins@wisc.edu
http://cfs.wisc.edu/home.aspx

Interests: Consumer financial behavior and literacy; consumer economics; mortgage markets and public policy

National Organizations

America Speaks
Washington, DC
http://americaspeaks.org/


Center on Budget and Policy Priorities
Washington, DC
http://www.cbpp.org/

Budget cuts or tax increases at the state level: Which is preferable when the economy is weak? (Brief, April 2010). Available at http://www.cbpp.org/files/1-8-08sfp.pdf


States continue to feel recession’s impact (Brief, October 2010). Available at http://www.cbpp.org/files/9-8-08sfp.pdf

Pew Center on the States
Washington, DC
http://www.pewcenteronthestates.org/


Wisconsin Family Impact Seminars

Resources

Tax Policy Center
Washington, DC
http://taxpolicycenter.org/

Effects of imposing a value-added tax to replace payroll taxes or corporate taxes (Report, March 2010). Available at http://taxpolicycenter.org/UploadedPDF/412062_VAT.pdf

What the housing crisis means for state and local governments (Brief, October 2010). Available at http://www.taxpolicycenter.org/UploadedPDF/1001459-Housing-Crisis.pdf

The Working Poor Families Project (WPFP)
Chevy Chase, MD
http://www.workingpoorfamilies.org/


Washington State Institute for Public Policy
Olympia, WA
http://www.wsipp.wa.gov


Benefits and costs of K–12 educational policies: Evidence-based effects of class size reductions and full-day kindergarten (Report, March 2007). Available at http://www.wsipp.wa.gov/pub.asp?docid=07-03-2201


Most policymakers would not think of passing a bill without asking, “What’s the economic impact?” This guide encourages policymakers to ask, “What is the impact on families?” When economic questions arise, economists are routinely consulted for economic data and forecasts. When family questions arise, policymakers can turn to family scientists for data and forecasts to make evidence-informed decisions. The Family Impact Seminars has developed this guide to help policymakers bring a family impact lens to policy decisions.

**HOW POLICYMAKERS CAN EXAMINE FAMILY IMPACTS OF POLICY DECISIONS**

Nearly all policy decisions have some effect on family life. Some affect families directly (e.g., child support or long-term care), whereas other influences are indirect (e.g., corrections or jobs). The following questions can help policymakers figure out what those family impacts are and how they can inform policy decisions.

**FAMILY IMPACT DISCUSSION STARTERS**

How will the policy or program:

- affect family members’ ability to carry out their responsibilities to one another?
- encourage family stability and influence whether members of a family stay together or break up?
- recognize the power and persistence of family ties, and promote healthy couple, marital, and parental relationships?
- affect families from different cultural, ethnic, racial, and religious backgrounds, geographic locations, and socioeconomic statuses; families with members who have special needs; and families at different stages of the life cycle?
- engage and work in partnership with families?

**Ask for a full Family Impact Analysis.** Some issues warrant a full family impact analysis to more deeply examine the intended and unintended consequences of policies on family well-being. To conduct an analysis, use the expertise of family scientists who understand families and policy analysts who understand the issue.

- Family scientists in your state can be found at [http://www.familyimpactseminars.org](http://www.familyimpactseminars.org)
- Policy analysts can be found on your staff, in the legislature’s nonpartisan service agencies, at university policy schools, etc.

**Apply the Results.** Viewing issues through a family impact lens rarely results in overwhelming support for or opposition to a policy or program. Instead, it can identify how specific family types and particular family functions are affected. These results raise considerations that policymakers can use to develop policies and programs that strengthen the contributions families make to their members and to society.
WHY FAMILY IMPACT IS IMPORTANT TO POLICYMAKERS

A growing body of evidence shows how investments in family policies can create the conditions for families to rear the next generation, economically support their members, and care for those who cannot always care for themselves. Yet families are also damaged by stressful conditions—the inability to earn a living, find quality child care, or send their kids to good schools. When the family foundation is strong today, children are more likely to develop the solid foundation they need for tomorrow—to become competent workers in a sound economy and caring, committed citizens in a strong democracy.¹

In polls, state legislative leaders endorsed families as a sure-fire vote winner.² Except for two weeks, family-oriented words appeared every week Congress was in session for over a decade; these mentions of family cut across gender and political party.³ The symbol of family appeals to common values that hold the potential to rise above politics and to provide common ground. However, family considerations are not systematically addressed in the normal routines of policymaking.

THE FAMILY IMPACT LENS IN POLICYMAKING EXAMINES:

► How families are affected by the issue
► In what ways, if any, families contribute to the issue
► Whether involving families in the response would result in better policies and programs

HOW THE FAMILY IMPACT LENS CAN BENEFIT POLICY DECISIONS

► In one Midwestern state, using the family impact lens revealed differences in program eligibility depending upon marital status. For example, senior citizens were less apt to be eligible for the state’s prescription drug program if they were married, than if they were unmarried but living together.
► In a rigorous cost-benefit analysis of 571 criminal justice programs, those most cost-effective in reducing future crime were targeted at juveniles. Of these, the five most cost-effective rehabilitation programs and the single most cost-effective prevention program were family-focused approaches.⁴
► For youth substance use prevention, programs that changed family dynamics were found to be, on average, over nine times more effective than programs that focused only on youth.⁵

ADDITIONAL RESOURCES

Several family impact analyses are posted on the web site of the Policy Institute for Family Impact Seminars at http://www.familyimpactseminars.org. Family impact analysis tools and procedures are also available.

Where research meets policy on family issues

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