

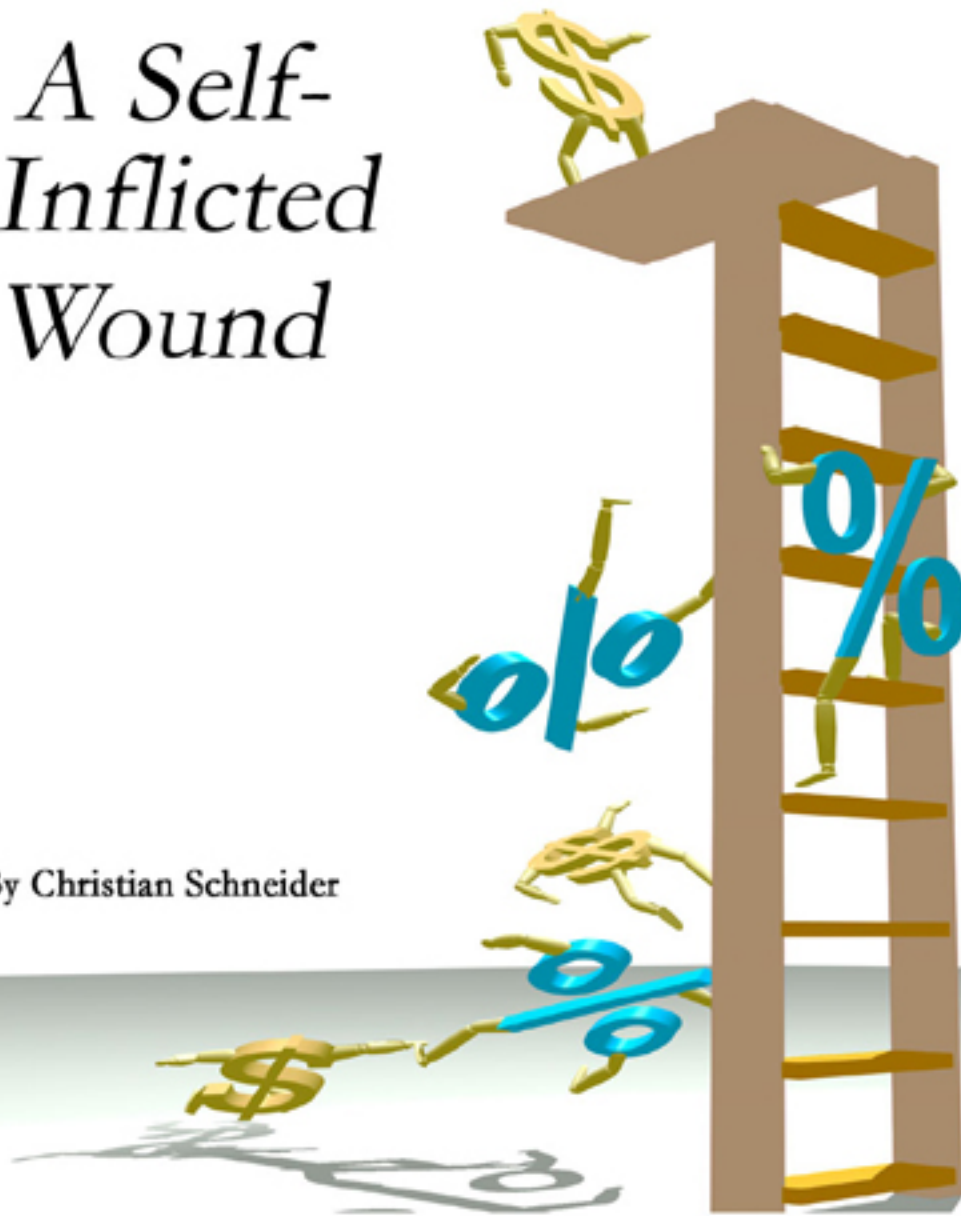
The Wisconsin Policy Research Institute

WPRI REPORT

The Wisconsin Budget Deficit:

*A Self-
Inflicted
Wound*

By Christian Schneider



THE STATE BUDGET DEFICIT: A SELF-INFLICTED WOUND

By Christian Schneider

February 1, 2009

On November 20th of 2008, Wisconsin Governor Jim Doyle settled into his seat at a packed Capitol press conference he called to deliver the bad news. Due to the slumping economy, Governor Doyle told the press, Wisconsin faced a \$5.4 billion shortfall over the next two fiscal years. In outlining his plan to fix the imbalance, Governor Doyle forcefully stated:

“We have to balance the budget. We are not the federal government. When we are in difficult financial circumstances, we can’t just say, ‘well, that’s alright, let’s just spend more money here, or let’s spend more money there.’ We don’t have that option.”

Yet an analysis of state budgeting practices over the past decade shows something much different. In setting the budget for the past several biennia, governors and legislators of both parties have employed several strategies that have allowed the state to spend more money than it takes in. When faced with balancing the budget or spending more taxpayer money, the Governor and Legislature virtually always side with spending as much as possible, leaving future government officials to address any shortfalls.

How did the state budget end up in shambles? Governor Doyle and supportive legislators lay the budgetary imbalance at the feet of the poor economy. State Senator Bob Jauch went so far as to call the budget shortfall “a natural disaster,” saying it was a “Katrina-style collapse.”

Yet despite these declarations that the budget shortfall is outside the control of Wisconsin’s elected officials, several questionable budget practices allow Wisconsin to continually spend more than it takes in. First, the state has been filling budget holes in the general fund by pouring in one-time revenues from segregated state accounts, paid for with various user fees. According to state government’s own financial records, from fiscal years 2001 through 2008, a total of \$2.373 billion of these one time, non-routine, revenues was used to help the general fund show positive ending balances. Much of this came from the transportation fund, which was then made whole by issuing debt to backfill the hole left by the transfer.

With regard to the spending side of the ledger, the state can appear to spend less from the general fund by “offloading” spending to accounts funded with user fees. For instance, in the 2003-05 budget, \$100 million was shifted out of the transportation fund and into the school aids equalization formula (\$40 million in 2004 and \$60 million in 2005). By replacing \$100 million of spending previously paid from general purpose revenue with segregated transportation funds, the Governor and Legislature sought to create the appearance that general fund spending was being held in check.

While the current economic recession is to blame for a good deal of state government’s fiscal troubles, the current pattern of the state spending more than it takes in has significantly exacerbated the problem. Even worse, the Governor and Legislature have set

aside virtually no budget stabilization funds to ameliorate such downturns – which makes the current recession much more damaging to the state’s finances. While the average state holds between 5% and 10% of their general fund revenues in a “rainy day fund,” Wisconsin keeps less than 1% in such a fund – allowing the state to spend that vital money on other ongoing programs, leaving the state’s finances in peril.

Wisconsin’s government revenues took a similar hit in 2001, when the national economy suffered through a recession that turned out to be fairly mild. Yet Wisconsin’s elected officials learned no lesson from that downturn. Once the economy began to turn around in 2004, the state began to spend beyond its means once again. Between 2004 and 2008, state general fund spending increased 25%, an average of 5% per year. If the state had merely held annual spending increases to inflation, general fund spending would have been \$943 million lower in 2008. Therefore, it would be fair to say that an elevated level of state spending made the current fiscal condition \$943 million worse.

This discussion is especially timely, given the prospective federal stimulus package Wisconsin is expected to receive upon passage by Congress. According to estimates, Wisconsin may receive up to \$3.5 billion in federal aid to fill in its budget hole. While doing so may get the state through the next two years, it could cause significant problems with state budgeting once the federal money evaporates. If Wisconsin uses the federal stimulus package as a one-time revenue plug, the state will struggle to balance its budget in the future, as it will either need to raise that revenue from its own citizens or cut programs drastically.

This report demonstrates that Wisconsin state government does not have a record of truly balanced budgets. Furthermore, due to the loopholes afforded it by the state constitution, the state has run up large deficits by using several reliable budget gimmicks, allowing it to continue to spend more than it takes in. The report recommends that state elected leaders do the following:

- Stop spending more than they are taking in.
- Set explicit long-term budget targets for spending in key areas, based on sustainable projections of affordable overall spending levels.
- Refrain from starting new state programs. If the state receives money from the federal government in the form of a stimulus package, it should use that money to fortify current programs and create a budget stabilization fund, rather than beginning new programs.
- Reduce the use of debt, and end the use of debt as an indirect substitute for current spending. Set explicit long-term targets for sustainable debt issuance and debt service levels.
- Fund meaningful budget reserves.

Introduction

Wisconsin has a severe budget crisis. The state's projected general fund budget deficit at the end of the 2009-11 biennium is a staggering \$5.4 billion, far higher than any projected budget deficit in the past, according to the report that the Department of Administration published on November 20, 2008 prior to the upcoming legislative budget session.

There has been a fair amount of discussion about why the state is facing a huge projected budget deficit. Clearly, the crisis is due in large part to the national recession which began a year ago and has worsened to become what may be one of the worst economic downturns since the Great Depression of the 1930s. The recession has led to an unprecedented decline in projected state tax revenues; revenue collections are expected to fall in two consecutive fiscal years for the first time in decades.

But it's a mistake to think that the projected budget deficit is due only to the recession. It should be remembered that during state budget deliberations in 2007 and in the spring of 2008, well before the extent of the present economic downturn became known, warnings were issued that the state faced a significant deficit in the upcoming biennium.

To a significant degree, the state's budget problems are due to the cumulative effect of bad budget practices which have persisted for the better part of the past decade, in good and bad economic times. A root cause of many of Wisconsin's fiscal woes is the state's practice over most of the past decade of spending more from the state general fund than it takes in from normal, ongoing sources of general fund revenue.

When a dam breaks and drains a lake, it creates a huge problem. It also tends to expose a lot of unsightly debris. The national recession has created some major problems, but it has also exposed some unsightly practices that were submerged for a long time, as subprime lenders, investment banks, auto companies and many other institutions – including governments – built new programs on shaky fiscal footing. Recent economic events have made it painfully clear that any organization that ignores economic fundamentals year after year will eventually have to face a day of reckoning.

As state policy makers take steps to deal with the state's immediate budget problems, they should also remedy the bad practices that helped create the present crisis, or else the problems will continue to haunt us in the future. It's important to face this issue squarely and take the opportunity to put state finances on a sustainable course in which ongoing spending and ongoing revenues are matched.

Wisconsin Has Been Spending Beyond Its Means

For many years, Wisconsin has been in the habit of spending more money from the general fund than it takes in from its normal, ongoing revenue sources. Put simply, the taxes and other revenues that Wisconsin routinely collects on an ongoing basis have not kept up with the state's desire to spend, causing a yearly imbalance. The state's tendency has been to patch over this hole with dubious fiscal strategies. This has been a bipartisan practice, participated in by governors and legislators of both parties.

Wisconsin's budgeting techniques have become increasingly complex in recent years, so it isn't easy to sort through the budget figures to see what's really going on. However, the state's published budget materials show how the state's general fund spending has been exceeding what have customarily been defined as general fund revenues.

The Wisconsin Constitution requires that the state budget be balanced. Each year, a determination about whether that requirement has been met is made based on the statutory accounting method that the Governor and Legislature have adopted. This method is used to present a general fund condition statement in the statutes after the passage of the budget in each legislative biennium.

(As an aside, it should be noted that the modified cash basis of accounting used in the statutory accounting method produces very different results from the accrual basis of accounting used under Generally Accepted Accounting Principles, or GAAP. For example, the statutory method of accounting used in the Annual Fiscal Report, or AFR, released by the Department of Administration on October 15, 2008 showed that the state had a positive general fund balance of \$131 million for fiscal year 2008. For the same fiscal year, the Comprehensive Annual Financial Report, or CAFR, released by the Department of Administration in December of 2008, showed that the state had a general fund deficit of \$2.5 billion using GAAP accounting. (The figures used in this report are generally taken from the AFR, based on the more lenient statutory accounting method which the Governor and Legislature have chosen to use.)

After each fiscal year ends, the state determines whether the budget was in fact balanced using the statutory accounting method when it issues the Annual Fiscal Report (AFR) on October 15 of each year. The general fund condition statement in the AFR shows the amount of money available each year from several sources: the opening balance carried over from the prior year, general fund tax revenues, and "departmental revenues." If the amounts available from these sources are greater than the amounts spent through appropriations, the general fund condition statement in the AFR shows a positive ending balance.

Wisconsin's general fund revenues are derived from several sources. The lion's share of general fund revenues comes from taxes. The major tax sources are individual income taxes (52% of state general fund tax collections in fiscal year 2008), sales taxes (about 34%), and corporate income taxes (about 6%). Various other taxes such as cigarette taxes, other excise taxes (e.g., alcohol taxes), public utility taxes and insurance company taxes also contribute to tax revenues.

For many years, a very small portion of general fund revenues has also come from what are called "departmental revenues," which are normal, everyday revenues received by individual state agencies and deposited in the general fund (rather than being deposited in a segregated fund dedicated to certain designated purposes). Together, taxes and customary departmental revenue sources have provided the state's general fund revenue stream. In the latter part of the 1990s, routine departmental revenues averaged only 1.6% of the state's general fund revenue stream.

This report will detail the most substantial budgeting practices that have allowed the state to spend more than it takes in, leading us to the current dire budgetary situation.

I. The Use of Non-Routine Revenues for General Fund Purposes Has Grown

One of the primary new strategies used by Wisconsin government to spend more than it takes in can be found in the increased use of one-time, non-recurring revenues. In recent years, a growing share of general fund revenues has been coming from these new revenue sources, most of which are one-time in nature. These have been labeled “departmental revenues” in the state’s general fund condition statement, but they are not the same as the normal non-tax revenues that had been counted as departmental revenues in the past. Rather, these have been one-time revenue infusions such as transfers of money from independent funds to the general fund, or accelerations of payment streams that the general fund has been scheduled to receive in the future, such as the money from the settlement of litigation with the major tobacco companies in the 1990s.

The state has become increasingly reliant on non-routine departmental revenues. The most extensive use of these revenues occurred during the budget shortfall in the 2001-03 biennium caused by the last serious national recession, when revenues from the securitization of the tobacco settlement proceeds were used to balance the budget.

Unfortunately, the state’s heavy use of non-routine departmental revenues has persisted since then, even when times have been good. In the six fiscal years since the last recession ended, departmental revenues have averaged 4.4% of the state’s general revenue stream, up from 1.6% in the comparable period of economic growth prior to the 2000-02 recession, with the difference due to the use of non-routine revenues. The use of non-routine revenues, previously resorted to only in recessionary periods, became chronic even in a time of economic prosperity.

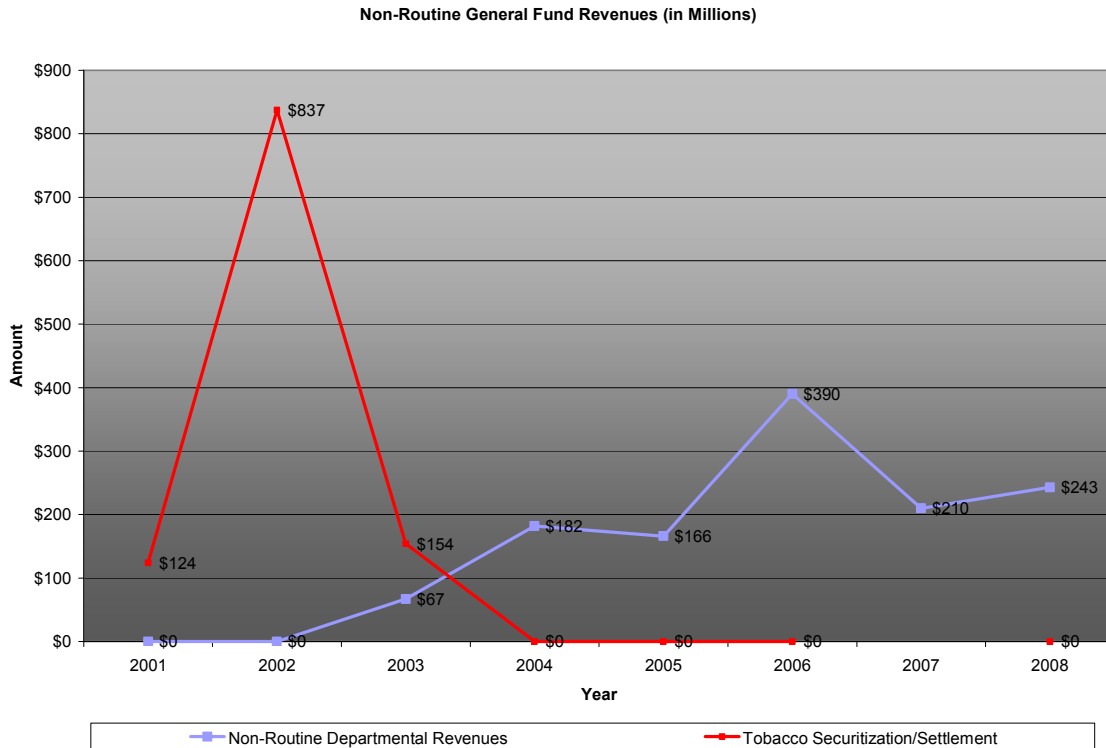
Figure 1 shows how the revenues that the state has received from non-routine sources have increased in recent years. The revenues that are classed as “non-routine,” non-ongoing revenues fall into two broad categories. First, they include revenues received from payments from tobacco settlement revenues that the state only received for a few years, or from the securitization and up-front payments of future tobacco settlement revenues. Second, they include transfers from other funds. While the tobacco securitization and settlement revenues spiked in 2002, other departmental revenues have climbed slowly since then.

The methodology for determining which revenues are non-routine is based on information in the AFR. Each year, the AFR breaks down the tally of revenues that are listed as “departmental revenues” in the general fund condition statement and shows the amount of revenues in that category that comes from interfund transfers. Exhibit A-1 of the AFR lists the amount of departmental revenues that are customary, routine departmental revenues. In separate lines, Exhibit A-1 shows listings for “transfers in” from other funds or for tobacco settlement or securitization revenues. Note F of the AFR states: “In order to properly compare actual revenues to budgeted revenues, the two, actual revenues and transfers, should be added together in order to compare to the departmental revenues in the fund

condition statements” for the budget approved by the Legislature and signed by the Governor.

Hence, the general fund condition statements that the Legislature and Governor use blend routine and non-routine departmental revenues, which is used to show a balanced budget each year. The AFR separates them, allowing a calculation of the degree to which one-time, non-routine revenues are being used to support general fund spending.

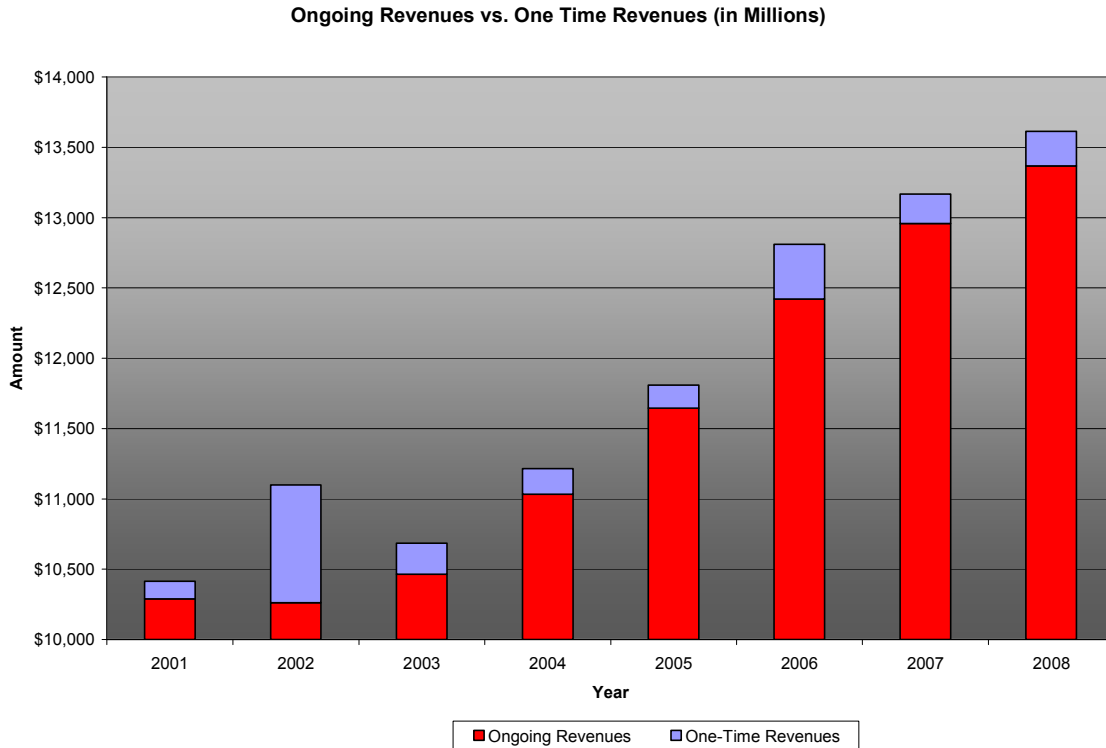
Figure 1



Non-Routine Revenues Make Up an Increasing Share of General Fund Revenues

The growth in non-routine revenues means that these outside funds have come to make up an increasing share of general fund revenues. Figure 2 shows that taxes and routine departmental revenues have been supplemented in recent years with tribal gaming revenues, tobacco settlement and securitization revenues, and non-routine departmental revenues in the form of transfers from other funds. Tribal gaming revenues are an ongoing source of revenue and therefore are listed as routine revenues. Once the state starts collecting them, it can expect the payments to continue year after year. But tobacco settlement and securitization revenues and transfers from other funds are revenues that are non-routine and not ongoing.

Figure 2

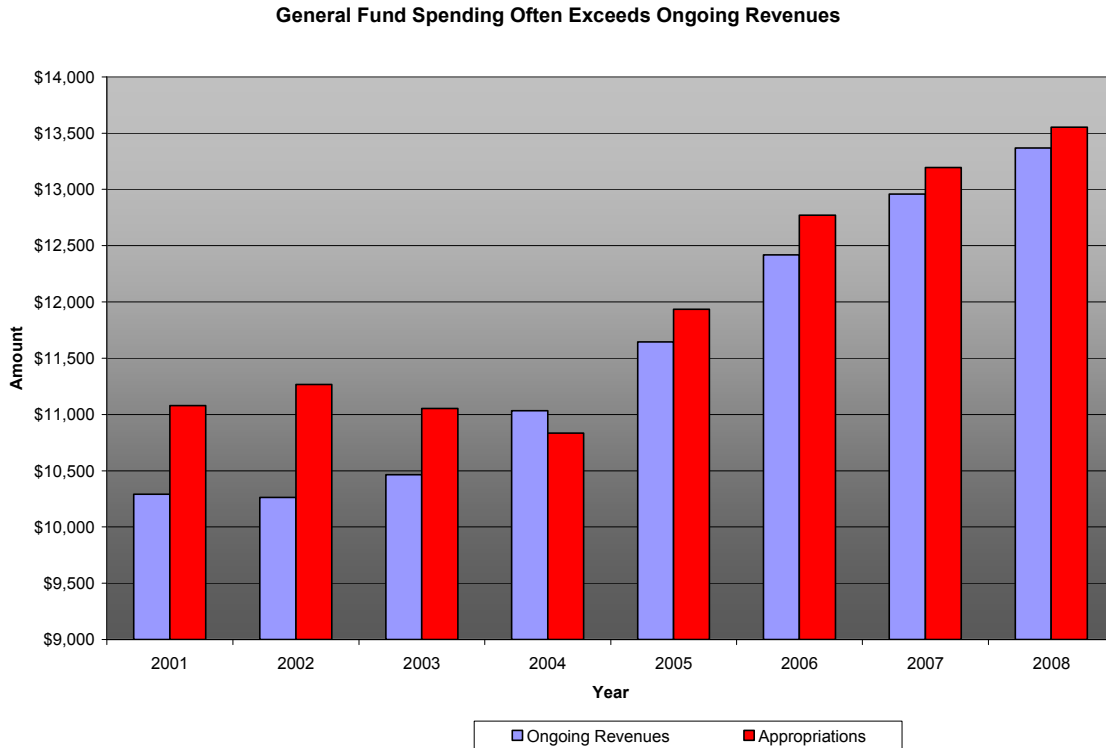


General Fund Spending Has Persistently Exceeded Ongoing Revenues

Once the amount of revenue from non-routine sources has been identified, several things become clearer. For one thing, it can be seen that the state has gotten into the bad habit of spending more than it takes in from ongoing revenues in most years. The use of various sources of non-routine revenues year has allowed the state to show that it has balanced the budget each year, even though ongoing spending has exceeded routine ongoing revenues.

Figure 3 compares ongoing state general fund revenues (tax revenues from individual income, sales, corporate income and other taxes, plus routine departmental revenues) to general fund appropriations for the past eight years. As can be seen, spending has outpaced routine, ongoing revenues in all but one of those eight years.

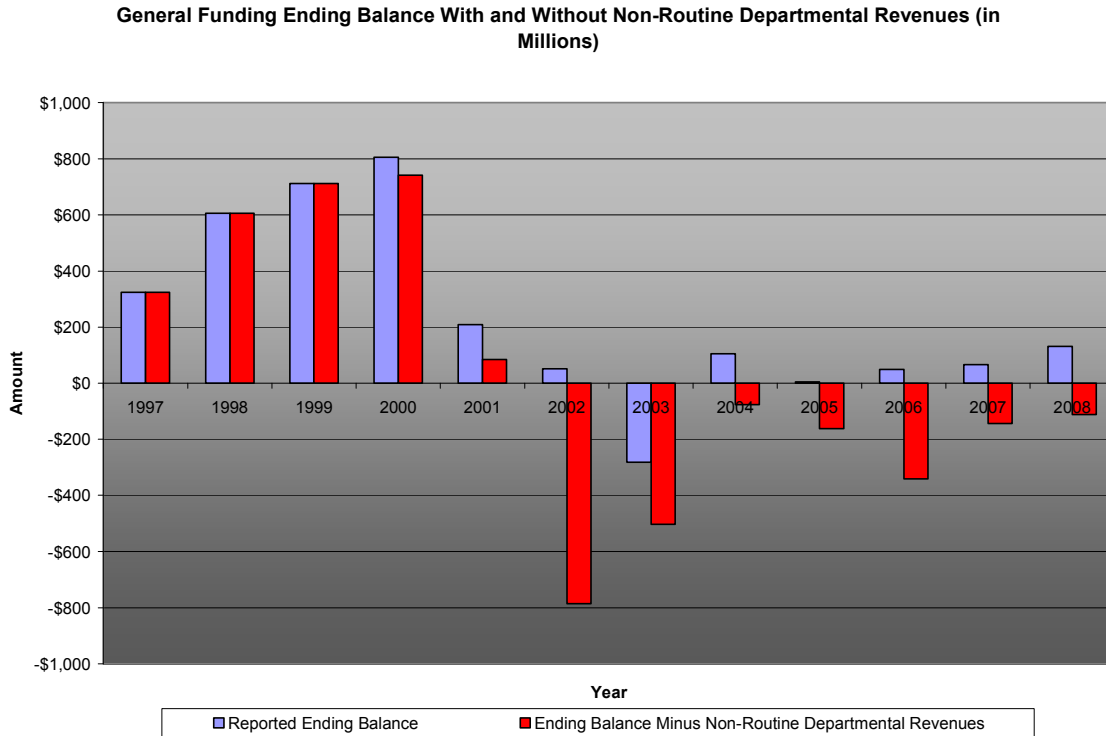
Figure 3



Wisconsin Would Have Continually Had General Fund Deficits Without the Use of Non-Routine Revenues

The increased use of non-routine departmental revenues has enabled the state to claim its books are balanced, when in fact they are not balanced on an ongoing basis, even using the lenient AFR accounting standards. Every year in the past decade, except for 2003, the state has reported a positive ending balance in its financial reports. To the untrained eye, it would appear as if the state's books are balanced – taxes and spending match up, with a little to spare. Yet when transfers in to the general fund are considered, the state actually has run a significant deficit. Figure 4 demonstrates what happens to state ending balances once fund transfers and other non-routine revenues are taken out of the equation. Without these revenues, the state would have had a deficit in each of the last seven fiscal years.

Figure 4



The Non-Routine Revenues that Have Allowed the State to Live Beyond Its Means Have Come From Several Sources

All told, from fiscal years 2001 through 2008, a total of \$2.373 billion in non-routine revenues was used to help the general fund show positive ending balances. These revenues have come from several different sources.

In fiscal years 2001 through 2003, state government plugged a large portion of the general fund hole by securitizing and spending much of the state's tobacco settlement money up front, rather than over a period of decades. The total amount of money received from tobacco settlement and tobacco securitization revenues for general fund purposes was \$1.115 billion. When this money ran out, it created an even bigger hole in future budgets, since the tobacco money was no longer available to buttress the general fund.

At that point, the state started using fund transfers in a major way. In fiscal year 2003, the state reported the use of \$67 million in non-routine departmental revenues from fund transfers to balance the budget. By fiscal year 2006, that number had ballooned to \$390

million, due in large part to a substantial transfer out of the transportation fund into the general fund. A practice that began in earnest with the use of securitized tobacco revenues became a common way to balance budgets throughout this decade.

A total of \$1.258 billion has been transferred from various funds to the general fund from fiscal year 2003 through fiscal year 2008. The largest amount, \$761 million, was from the transportation fund. However, this was by no means the only source of transfers. Another \$497 million was from a variety of other sources, including the Petroleum Inspection Fund, the Recycling Fund, the Utility Public Benefits Fund, the Environmental Fund and the Universal Service Fund.

Consequences of the Use of Non-Routine Revenues

The use of non-routine departmental revenues is troubling in several ways. It creates a hole in the budget the next time around, because the programs are ongoing, but the funding sources are not. In those cases, taxes either must be raised or programs must be cut in order to retain a balanced budget – unless, of course, the state decides to up the ante and transfer even more funds from general fund sources. For example, the state’s continual raid of the transportation fund to plug the general fund almost certainly led to a proposal to raise the tax consumers would pay on gas in the 2007-09 budget.

The use of non-ongoing revenues can cause fiscal aftershocks that can damage the state’s economic standing in the future. Again, the transfers out of the transportation fund in the past three budgets demonstrate this – since the funds pulled from the transportation fund were replaced with bonding, and the interest on that state debt will continue to haunt taxpayers for decades. In 2003, the state budget raided \$22 million from the Petroleum Inspection Fund in the Department of Commerce, which also uses bonding as its funding source. So while the general fund ended up \$22 million richer, debt service on the Petroleum Environmental Cleanup Fund Award (PECFA) bonds issued to generate that revenue will end up costing taxpayers a great deal more in the future.

Funds are often pulled from departmental accounts unrelated to general fund purposes. For instance, the state may raid the Environmental Fund at the Department of Natural Resources for help with the general fund. Yet hunters and fishermen don’t pay fees for the purpose of aiding the school equalization formula. They pay their hunting and fishing fees with the expectation that those fees will help re-stock fish and improve habitat. The same theory applies to any number of segregated accounts the state holds. Using those funds for something other than their stated purpose breaks a trust formed with the fee payers.

II. Spending Shifts Have Helped Obscure the Revenue-Spending Mismatch

As demonstrated above, revenues can be manipulated through the use of one-time money to make it appear as though the budget were balanced. But revenue is only one side of the ledger – spending may also be creatively shifted to bring the budget into apparent balance.

One dubious budget strategy is using money that had previously been deemed general fund revenue for purposes that were formerly deemed general fund spending while identifying the revenue and related spending with different labels. For instance, in the 2003-05 budget, \$100 million was shifted out of the transportation fund and into the school aids equalization formula (\$40 million in 2004 and \$60 million in 2005). By replacing \$100 million of spending previously paid from general purpose revenue with segregated transportation funds, the Governor and Legislature sought to create the appearance that general fund spending was being held in check. What was really happening was that a portion of school aids was being paid for by people who pay the automobile registration fee.

In the 2007-09 budget, the Governor and Legislature raised the state's cigarette tax by \$1.00 per pack. Previously, excise taxes on cigarettes were considered general fund revenues. Yet the 2007-09 budget instead deposited the revenues from the increased cigarette tax to a new "Health Care Quality" segregated fund. This fund was then used to supplant \$300 million in general fund spending for Medicaid, making it appear as if the government had reduced general fund appropriations by \$300 million. Instead, the spending was still there, but it was technically classified in a different category, enabling the Governor and Legislature to claim a lower level of general fund spending as compared to prior budgets.

The spending levels used in Figure 4 are the official general fund appropriation numbers as reported by the Department of Administration, yet these numbers do not take into account spending "conversions," or offloading general fund expenditures on to program and segregated revenue accounts.

III. Spending Beyond Our Means Leads to Inadequate Budget Reserves

State governments can cushion the effects of economic downturns by maintaining adequate reserve funds which can be drawn on in economic downturns. However, Wisconsin has not set aside a prudent budget reserve, despite repeated urgings. The mismatch between spending and revenues has meant that the state has not had revenue available for a reserve fund.

Underfunding a “rainy day fund” is both a cause of budget problems and an effect of poor budgeting decisions. When Wisconsin decides to spend more than it takes in, underfunding the budget reserve is one of the easiest places to save money. For years, Wisconsin has neglected to put money in the reserve and left an almost immaterial minimum statutory balance – and it is feeling the detrimental effect of both actions now. With no rainy day fund on which to draw, higher taxes and damaging cuts are the most likely ways out.

According to the National Association of State Budget Officers (NASBO), nationwide ending balances reached 10.4% of expenditures in 2000, and 9.4% in 2001. During the 2001 recession, states were able to draw on \$25.8 billion of reserves to help balance their budgets. As a result, ending balances were reduced to 3.7% of expenditures. Balances built up over the previous years helped ameliorate many of the budget problems caused by lagging revenue.

Following the recession in 2001, most states set aside significant amounts of money in budget reserves. In 2006, nationwide ending balances in state budgets had reached \$62.1 billion, or 10.9% of expenditures. Increased revenue due to a growing economy contributed to these new funds, as states learned the importance of setting aside money for emergencies.

Wisconsin never learned its lesson. Wisconsin remains one of only four states with a minimum statutory balance under 1% of expenditures. Wisconsin had ending balances of 0.4% of annual spending in 2006 and 0.6% in 2007, and budgeted a minimum balance of 0.4% in the fiscal year 2008 budget. This compares to a nationwide average of 8.2% in 2007. By the standards set by other states, Wisconsin’s government has been running on fumes.

While views of budget experts vary, an informal standard of 5% of general fund appropriations is generally seen as an adequate fiscal cushion for economic downturns. If Wisconsin were to reach the 5% standard, it would have needed to set aside \$691 million in 2007-08 and have \$710 million in reserve in 2008-09.

In January of 2008, WPRI suggested several steps Wisconsin could take towards fiscal responsibility in order to protect itself against declining revenue. Among them:

- Phase in greater minimum statutory balance levels, up to a balance of 2% of gross annual appropriations. For instance, start with a 1% balance one year, 1.2% the next year, 1.4% the next, until the balance reaches 2%. Under currently budgeted numbers, that would require setting minimum balances of \$138.2 million in 2008 and \$170 million in 2009.

- Phase in a requirement that the state fund the stabilization fund up to 5% of gross appropriations. Require that appropriations to the stabilization fund be the first draw on general fund revenue growth to the state, except during recessions.
- Require that all unanticipated revenues be deposited in the state's budget stabilization fund, until the fund reaches 5% of gross appropriations. Current law only requires 50% of these revenues to be deposited in the stabilization fund.
- Continue the provision that, in the event of a fiscal emergency, the Governor may introduce a bill to draw down the stabilization fund and the minimum balance. Require a two-thirds majority of both the Senate and Assembly to appropriate these funds, to ensure that they don't merely become easily accessible pools of money.
- Initiate legislative action to make these requirements constitutional. As has been seen recently, statutory minimum balance and stabilization fund requirements are only as enduring as the commitment to prudent fiscal management. The Governor and Legislature have routinely suspended these requirements.

IV. Spending Beyond Our Means Leads to Increased Debt

The mismatch between spending and revenues has also led to an increased reliance on debt to backfill the holes created when money has been transferred to the general fund. While debt has traditionally been used in Wisconsin for capital or “brick and mortar” projects, the state has been issuing bonds to indirectly buttress ongoing spending at an alarming rate.

In the past three budgets, the Governor and Legislature have generously used debt to fund ongoing appropriations indirectly. Additionally, new types of bonds have been created that allow government to circumvent the constitutional prohibition on bonding for general operating expenses. In several instances, Wisconsin’s elected leaders opted for short-term gain over long-term fiscal responsibility, and their creation of new types of borrowing carried risks for the future.

In 1969, when the state constitution was amended to allow the state to issue bonds, Wisconsin had \$392.8 million in outstanding debt. In December of 2006, Wisconsin had \$19.3 billion in outstanding debt, or \$3,476 for every state resident. Shortly before the 1969 constitutional amendment passed, Wisconsin ranked 40th in the nation in state debt per capita. By 2003, Wisconsin had risen to 10th in per capita debt outstanding – and state debt has increased substantially since then.

Furthermore, the state has issued debt in excess of taxpayers’ ability to support that debt. In 1979, outstanding GPR supported GO bonding was 16.1% of state GPR revenues. By 2006, that number had more than doubled, to 33.9%. GPR funded GO bonding has grown substantially in relation to tax revenue.

However, more important than the mere issuance of debt is the purpose for which bonds are issued. When a government issues debt for a building project, at least the state gains an asset. But when governments issue bonds to help indirectly fund ongoing revenues, it causes significant fiscal problems in the future. Bond revenue is one-time in nature; while the money is there for its immediate purpose, it is gone in the next biennium, since there is no dedicated revenue stream. Additionally, bonds must be paid off with interest – over the life of a 20 or 30-year bond, the state may end up paying more than twice back in interest as it gained with the initial bond issue.

Transportation Bonding to Benefit the General Fund

Between 2003 and 2008, the Governor and Legislature transferred a total of \$1.1 billion out of the transportation fund to pay for unrelated programs, the bulk of which went to the general fund, and back-filled those transfers with \$815.5 million in new bonding, as shown in Figure 5.

Figure 5
Transfers and Revenues In and Out of Transportation Fund
(in millions of dollars)

	2003- 05	2005- 07	4-Year Total
Transfers and Appropriations Out	\$675.0	\$427.0	\$1,102.0
General Obligation Bond Rev. In	565.5	250.0	815.5

Source: Legislative Fiscal Bureau, 2007 Informational Paper 40, "Transportation Finance."

As Figure 5 shows, the net effect of the transfers has left the transportation fund with a \$330.4 million reduction over a four year period (once \$43.9 million in debt service is accounted for). This prompted Governor Doyle to propose gas tax and vehicle registration fee increases in his 2007-09 budget to make up for the lost revenue.

Figure 6 shows that the use of bonding has grown faster than revenues to the transportation fund. Most notably, debt service has increased significantly in the past six years, from 7% of gross revenues in 2001-02 to 11.8% in 2006-07, due mostly to bonds issued to fill the hole left by transfers from the transportation fund to the general fund. (The number dipped in 2005-06 due to debt service on transportation bonds being paid from the general fund, rather than the transportation fund, but then bounced back up.)

Figure 6
Debt Service Payments from Transportation Fund
(in million of dollars)

Fiscal Year	Total Debt Service	Gross Revenues	Debt Service as % of Revenues
1995-96	\$67.3	\$1039.8	6.5%
1996-97	\$76.4	\$1047.4	7.3%
1997-98	\$78.7	\$1141.7	6.9%
1998-99	\$87.4	\$1235.1	7.1%
1999-00	\$90.3	\$1271.1	7.1%
2000-01	\$94.5	\$1283.4	7.4%
2001-02	\$93.3	\$1337.7	7.0%
2002-03	\$105.8	\$1386.6	7.6%
2003-04	\$119.7	\$1440.4	8.3%
2004-05	\$166.2	\$1482.9	11.2%
2005-06	\$148.2	\$1523.3	9.7%
2006-07*	\$184.9	\$1566	11.8%

*Estimate

Source: Legislative Fiscal Bureau 2007 Informational Paper 40, "Transportation Finance."

The debt service on the replacement bonds continues to grow. In the 2007-09 budget, debt service on these bonds will cost the state \$175.9 million. By the time the \$815.5 million in replacement bonds are repaid, Wisconsin taxpayers will have paid an additional \$1.1 billion in debt service on the bonds, above and beyond the principal owed.

Appropriation Bonds

While not all bonding is necessarily detrimental to the state's economic condition, the creation of a new class of bonds may prove to be a poor precedent for future budgets.

Facing large budget deficits and declining state revenues, Governor Jim Doyle in 2003 proposed what he called "appropriation bonds" for the purpose of refinancing the state's unfunded pension liability and accumulated sick leave conversion programs. Historically, the state has issued bonds that are either General Obligation - paid for with GPR and carrying the state's moral obligation pledge - or Revenue Bonds - paid for by a dedicated stream of other revenues and not carrying the moral obligation. According to the Wisconsin Constitution, General Obligation bonds cannot be issued for ongoing state appropriations.

But these new appropriation bonds are paid for with general purpose revenue and carry the state's moral obligation. The only difference is a slight technical difference in how the GPR is appropriated - for traditional GO bonds, it is an automatic payment, while with appropriation bonds, the Legislature must proactively fund the bonds separately in the budget. And that is the

only difference. (It is unlikely the state would ever fail to appropriate the necessary debt service on these obligations, because doing so would jeopardize the state's credit rating.) Basically, they are GO bonds, but they circumvent the prohibition on issuing debt for ongoing state programs.

At the time the appropriation bond plan went to the Legislature for review, the Legislative Fiscal Bureau questioned the appropriateness of this broad expansion of bonding authority. In a memo to the Joint Committee on Finance, they noted that "using general fund revenues to pay off revenue obligation bonds or GPR funding to pay the appropriation bonds authorized under the bill could establish a precedent for the state's debt programs." They further warned that "such borrowing programs that use state general fund revenues to support debt that is not constitutionally limited in its use or amount, could be statutorily expanded to support bonds that could be issued for any state government operating function or expense." However, the Legislature chose not to heed the warning and proceeded to approve the Governor's proposal.

Tobacco Securitization

In the 2001-03 biennial budget, Governor Scott McCallum faced a significant shortfall in state revenues. In order to fill the hole caused by lagging state revenue, the Governor proposed "securitizing" the stream of revenue state government was to receive from the multi-state tobacco master settlement agreement. In essence, the state would take a large, one-time lump sum payment rather than payments that were scheduled to be paid by the tobacco companies over a 30-year time period. State government then used the proceeds to address a shortfall in the general fund.

Aside from merely filling a budget hole, supporters of securitization argued that it would be wise to maximize revenue from the tobacco settlement while it was still available. They argued there would be no guarantee the tobacco funds would be available, given possible litigation and other circumstances. Furthermore, the McCallum administration had to make the choice between securitizing the tobacco funds or raising taxes.

At the time of Wisconsin's proposal, several other local and state governments had utilized securitization for various needs. Some used it to get around constitutional limits on debt issuance, while others used the proceeds for capital projects. Still others used securitization bond revenues to set up health care endowments or rainy day funds.

The one-time lump sum payment was achieved by setting up a nonstock corporation to issue revenue bonds on behalf of the state. In April of 2002, the Badger Tobacco Asset Securitization Corporation issued \$1.59 billion worth of revenue bonds, \$1.275 billion of which were available to the State of Wisconsin to balance the budget. The debt service on the bonds is paid for with the yearly revenue from tobacco company payments. It is anticipated that the bonds may actually be paid off sooner than expected, which would then allow the state to reclaim the settlement payments as early as 2018. As of December 2006, the Corporation still had \$1.46 billion in bonds outstanding.

While the revenue bonds issued to finance securitization may have been self-funding, the decision to take the lump sum amount to balance the state budget had other ramifications.

The use of one-time money to support ongoing government operations created a hole in the next budget that required new revenue to fill.

V. Recommendations for Changes

What should the state do to end its reliance on non-routine, non-ongoing revenues to support current general fund spending? The first thing the Governor and Legislature must do is to admit that they have fallen into the very bad habit of using short-term revenue fixes to support general fund spending even during good economic times. They need to acknowledge that we face serious long-term fiscal problems, caused in part by the persistence of dubious budgeting practices as well as by short-term economic conditions. Hopefully this report will help in clarifying the confusing movements of funds and showing clearly that state government has had an ongoing problem for a number of years.

After that, state policy makers should do the following:

- Stop spending more than they are taking in. They must commit to matching ongoing general fund spending with ongoing general fund revenues.
- Set explicit long-term budget targets for spending in key areas, based on realistic projections of affordable overall spending levels over time, so each budget does not result in an ad hoc scramble for revenues from any short-term sources people can think of to fund short-term spending increases.
- Refrain from starting new state programs. If the state receives money from the federal government in the form of a stimulus package, it should use that money to fortify current programs and create a budget stabilization fund, rather than beginning new programs.
- Reduce the use of debt, and end the use of debt as an indirect substitute for current spending. Set explicit long-term targets for sustainable debt issuance and debt service levels.
- Provide funding for meaningful budget reserves.

There is always a great temptation to use different non-routine, non-ongoing revenue sources to fund general fund spending. This trap is very alluring, especially if the use of non-routine revenues is implemented through a series of complex transfers that are not easy for the general public to understand.

In the short term, this allows policy makers to avoid spending cuts. But in the long term, the practice can't be sustained. Funds that have been raided are running out of money. Debt service payments are rising to levels that will hamstring the operations of other funds. At that point, drastic spending cuts or big tax increases become the only available options.

The 2009-11 state budget represents an opportunity to put all aspects of the state's spending and revenue practices under review. The Governor and Legislature will be working on the budget at a time when it's become obvious that constructing more and more elaborate financial structures that aren't fundamentally sound won't work over the long term. Hopefully, the Governor and Legislature will take this opportunity to put in place sound, sustainable budget practices that lead to a fiscally stable future.