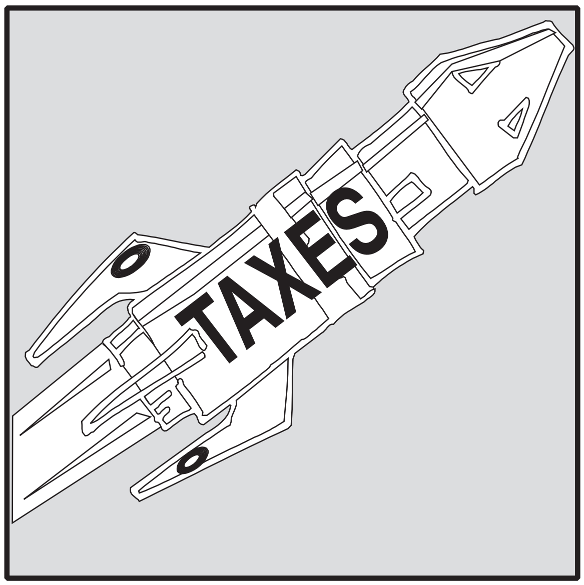
Invest, Invest, Invest

Wisconsin's Coming Spending and Tax Explosion

Charles J. Sykes



Wisconsin boasts the third highest state and local tax burden in the country, consuming 13 percent of personal income in the state. Only Maine and New York have a worse tax climate. Last year the total tax bill for state and local government rose 7.3%, to $18.8 billion, the largest percentage increase since 1984.

It is about to get worse.

Think of the state budget as a dam: even though spending and taxes have been continually rising over the last decade, it can't keep pace with pent-up pressure to spend even more money. Cracks are beginning to form and the tide is rising.

Consider: Despite facing a softening economy, a nightmarish tax burden and a $760 million budget shortfall, Senate Democrats unanimously passed a budget in mid-June that *increased* spending by more than $300 million and imposed hundreds of millions of dollars in new taxes on the state's businesses and consumers.

The spending binge included: money to pay for voice-mail for the homeless; a costly new medical entitlement; tens of millions of dollars in education spending and looser limits on property tax increases; taxes on garbage, telephones, and businesses. The budget was extraordinary for its promiscuity: $3.1 million for Milwaukee nursing homes; $27 million for a research park in Milwaukee; $250,000 for an African-American Family Resource Center in Milwaukee; $100,000 for a Multicultural Center in Green Bay; $1 million for the restoration of a railroad depot in Ashland; $2.37 million for construction of a visitor center and administration building at the Kickapoo Valley Reserve; $250,000 for a health education center at the Chippewa Valley Technical College; $99,500 for an asphalt parking lot for a new baseball field and stadium at UW-Parkside; $131.5 million for a Wisconsin History Center in Madison; and so on.

State legislators could not bring themselves to say no to anyone. Even the compromise "bipartisan" budget sent to the Governor called for borrowing a stunning $709 million for capital projects. One headline writer dubbed it a "kitchen sink" budget.

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In the end, of course, most of the anti-business measures were removed in negotiations with Assembly Republicans or by Governor McCallum's veto pen. But as a blueprint for the future, the Senate budget was unsettling.

Faced with a massive budget hole, Democrats in both houses opted for huge increases in both spending and taxes. And despite controlling two-thirds of state government, Republicans were on the defensive on health care and education spending, yielding on key points.

Some observers suggest that many of the spending and tax items in the Senate budget were included merely as bargaining chips for negotiations with Assembly Republicans. But the budget votes also reflected the shift in the ideological center of state politics. Pro-business Democrats like Shirley Krug and Antonio Riley are in eclipse, as party leaders move sharply to the left (see accompanying article on Spencer Black).

While none of the Democratic gubernatorial candidates embraced the budget, neither did they repudiate it. And at least at the legislative level, Wisconsin Democrats no longer even pretend to be a party of fiscal restraint.

This would seem to raise a fundamental — and urgent — question: If Democrats go on to win the governor's office and the legislature next year — as many pundits predict they could do — will they interpret those victories as mandates for even more expansive "investments"?

In particular, Democrats would owe a huge debt to the organizational and financial support of the state's largest teachers' union, WEAC, which is likely to demand a suitable reward in the form of new spending and the removal of limits on the ability of local school districts to raise property taxes.

Making the tax climate even darker was the current legislature's fiscal sleight of hand, which will leave the next budget nearly $1 billion in the hole.

Since there is no money left for new spending, the only alternative will be dramatic increases in taxes at every level of government. Unfortunately, this is not purely speculative. The state Senate budget laid out a detailed blueprint of what the next round of tax increases might look like.

As the dam breaks, however, Republicans will not be entirely blameless. Their own policy blunders — on spending and taxes — make spending restraint more difficult, even as they make raising taxes easier.

By committing state taxpayers to paying two-thirds of the cost of K-12 education, Republicans acquiesced in what has become a $5 billion entitlement that is both a fiscal albatross and a powerful excuse to drive education spending higher.

At the same time, Republican budget-writers set the stage for a soak-the-rich tax hike by creating a new tax bracket for joint filers with incomes over $155,850 ($116,890 for singles) — an almost irresistible target for liberals in search of politically popular tax increases to pay for new spending.

Anatomy of a Tax Hell

Last June's spending binge needs to be put in context. Wisconsin is no longer a state flush with cash; nor has its ability to pay kept pace with government's appetite.

Over the past decade, state government has spent essentially whatever came in the door. For most of that time, the state's economy was robust, but the state and local tax bite outpaced both inflation and the growth in personal income.

During the 1990s, total tax collections in the state grew at a rate of 6.5% annually, while personal income rose by only 5.5% a year.

One consequence was that we continued to lead the country in taxes, while lagging in our ability to pay those higher taxes. Despite the fact that per capita income in Wisconsin has been about 4% below the national average since the mid-1990s, state and local taxes continue well above the national average. According to the Wisconsin Taxpayer's Alliance, the state's tax effort "remains 17%

above the national average, while its tax capacity, or ability to pay, remains 3% below."

Despite this, government spending at both the state and local levels continued to grow. County governments, for instance, increased their spending nearly three times the rate of inflation — jacking up spending by 78.6% during he 1990s, at a time when the CPI rose by only 27.5%.

Spending on education also rose rapidly during the decade. Even though the teachers union continues to insist that schools are underfunded, Wisconsin continues to spend 22.7% more on K-12 education than the national average.

All of this generated immense pressure on the state treasury. As legislative leaders began work on the 2001-2003 biennial budget, the fiscal picture looked especially grim. State fiscal experts warned that lagging tax collections meant that revenue would fall $760 million short of proposed spending. In other words, state taxpayers were no longer able to keep pace with state government's rate of spending growth.

The combination of the state's high tax burden and shortage of cash ought to have been a signal for fiscal restraint.

Instead, it set off a spending and tax riot.

Throughout May and into early June, the Joint Finance Committee repeatedly deadlocked on spending issues on 8-to-8 party line votes. By the time the committee wrapped up its work, Democrats from both the Assembly and the Senate had tried and failed to add more than $250 million in new spending to the package. But this was dwarfed by the package Senate Democrats endorsed in mid-June. Even conceding that some of the items were included as negotiating chips, the Democratic agenda was breathtaking in its size and its overt hostility to business.

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Overall, the budget raised taxes and fees by $350 million and increased state borrowing by a half-billion dollars. Despite the tight budget, the Senate budget created costly new entitlement programs — a prescription drug plan that was estimated to cost $103 million the first year alone. Senators paid for the plan by voting to increase cigarette taxes by $158 million.

That was just for starters.

In a possible preview of future budgets, the senate budget not only raised state business taxes, but created and expanded revenue sources at every level of government by taxing telephones, ATMs, and garbage. The Senate budget:

- Increased business taxes by $19.5 million by limiting deductions for any compensation paid to an employee or officer to 25 times the pay of the business's lowest-paid employee. Democrats, who endorsed this measure unanimously, called it the "Income Equity Act."
- Allowed local schools to raise property taxes above current revenue limits. Raising the caps would cost the state at least $49 million in additional state aid, on top of inevitable property tax increases.
- Raised corporate and franchise taxes by $98 million, through combined reporting requirements.
- Gutted the QEO — which limits teacher salary increases — by exempting increases in health insurance premiums that exceed the rate of inflation. (A double gift to WEAC, since the union itself sells health insurance to many of the state's teachers.)

- Eliminated the property tax exemption for ATM machines, which would cost businesses and consumers at least $1.1 million a year.
- Raised $60 million in new local taxes through a new 2% local option tax on telephone companies.
- Raised $3.5 million in taxes by shrinking the amount of money taxpayers can deduct from state taxes through the property tax / rent credit
- Raised $3.87 million in new taxes on telecommunication providers to make up for a shortfall in the Wisconsin Advanced Telecommunications Fund.
- Raised a half-million dollars in new taxes on cell phone services.
- Allowed local governments to charge "fees" for municipal services, such as fire protection.
- Raised $29 million in additional taxes by de-coupling Wisconsin's tax code from the federal government, which is cutting the tax.
- Increased the minimum wage to $7.05 an hour — an item that would cost the economy about $6 million a year.
- Imposed a $65.1 million increase in taxes for the state recycling program.

Despite murmurs of dissent, not a single Democratic senator voted against the package. If there were pro-business moderates or fiscal conservatives in the caucus, none of them were willing to challenge the budget crafted by Majority Leader Chuck Chvala.

And while it shocked the state's business community, the budget was applauded by many of the party's core constituencies as a sign that state Democrats were committed to investing in health care, education, and the environment, even if it meant sharply higher taxes on business.

Indeed, Senate Leader Chuck Chvala outlined his philosophy shortly after the budget votes, in an article in which he argued that the Democrats' policies would, in fact, "grow" the state's economy, regardless of their cost to taxpayers. In the article, Chvala used the terms "invest" or "investments" eight times in 12 paragraphs. His spending plan, he insisted, "invests in the 'human infrastructure' of our state" by increasing spending for the UW system and K-12 education.

Dismissing out of hand concerns about the state's tax climate, Chvala noted that Minnesota has higher per capita state tax collections that Wisconsin, yet has a thriving economy. "Clearly," he concludes, "it is education and access to a well-trained workforce — *not tax climate* — that drives the decisions of the new high-tech economy."

The Politics of Investment

The use of the euphemism "investment" to describe increased government spending is neither new nor strictly a phenomenon of Wisconsin politics. Bill Clinton successfully deployed it early in his presidency to push a variety of spending plans. But as pent-up pressure to expand spending has grown here, the term has enjoyed a resurgence of popularity, especially for the teachers' union and their allies, who continue to chafe under state limits on property tax and school spending increases.

An increasing number of school districts have successfully persuaded voters to spend tens of millions of dollars over and above the revenue caps on construction projects and other enterprises.

In part, the referendums have succeeded because of the prospect of "free" state money (the state picks up two-thirds of any new spending plan); but they also indicate the political appeal of calls to "invest" more in education.

And "investing" in the future of children is the constant theme of the state's newly elected school superintendent, Elizabeth Burmaster, who passionately advocates both higher spending and taxes to pay for schools. On election night, she passionately denounced attempts to balance the budget "on the backs" of the state's schoolchildren. Interpreting her election as an endorsement for higher spending on schools, she even suggested using the state's gas tax — which rises automatically with inflation — as a model for school tax increases.

In the budget debate, Burmaster and Senate Democrats pushed for sharply higher spending on the state's SAGE program, funding for special education, four-year-old kindergarten, and lifting the revenue caps on local school districts. In the end, despite the state's budget hole, she got much of what she wanted, because Republicans blanched at the prospect of appearing anti-education.

If there is any issue that clearly has the momentum in state politics it is the push to loosen the property tax caps on schools — or to render them porous and meaningless.

Ironically, previous legislatures and Governor Tommy Thompson had thought they had immunized themselves against such pressures by committing to paying two-thirds of the cost of public schools. Originally, the idea was to provide property tax relief by a massive infusion of state tax dollars. In the past, such infusions had merely proven an incentive for local school districts to increase their spending. State aid ended up merely being an incentive for increasing local property taxes.

Legislators who approved the two-thirds deal thought they were avoiding that scenario by limiting teacher salary increases (the QEO) and capping local property taxes. For a while this worked and school property taxes were held down. But in recent years, that restraint has been replaced by a burst of new spending.

The much-despised caps did not starve public education in Wisconsin.

Almost from the beginning of the caps, WEAC and its allies have begun a drum-beat of criticism, complaining that teachers had been unfairly singled out and complaining that schools were being placed in an unfair fiscal strait jacket.

But has education really been shortchanged under the revenue caps? As it turns out, the revenue caps are being blamed for a problem that appears not to exist. State aid to K-12 education has risen from less than $1.9 billion a year in 1990 to nearly $5 billion. School tax levies rose from $2.3 billion to more than $2.9 billion. This has helped boost total school costs from $4.5 billion to nearly $8 billion in the last decade.

The much-despised caps did not starve public education in Wisconsin. To the contrary, when spending is adjusted for inflation, school spending in Wisconsin actually grew faster after revenue caps were imposed than before. In the six years between 1988 and 1994, (the year the caps took effect), school spending had risen by 9.7%. In the six years after the caps were in place, spending rose by 12.2%.

Even so, both the teachers' unions and local school districts have continued to complain about low teacher pay and niggardly budgets. Even though neither charge is fair, the constant refrain, magnified by WEAC's media campaigns and reiterated by the state's media, has re-enforced the public's perception that school spending has been niggardly and built momentum for significant increases in tax support for education.

The compromise "bipartisan" budget deal reflected the success of that campaign. The budget included a spending cap, limiting the growth in state spending to no more than the growth in personal income. But it exempted education spending — a gaping loophole that renders the rest of the spending cap more or less meaningless.

Should WEAC succeed in installing a friendlier governor and legislature next year, it seems reasonable to assume its top priority will be gutting the remaining restraints on increases in school spending. The teachers union is on record favoring the complete repeal of the caps.

Wisconsin will then have the worst of both worlds: a massive blank-check state commitment to fund two-thirds of K-12 education; *as well as* skyrocketing property taxes, driven in part by the fact that local taxpayers will be told that the state will chip in two dollars for every dollar they spend.

Budget Crunch

Unfortunately, the next governor will find that the bank for all of this new spending is busted.

Even as the next governor comes into office, he or she will be confronted with an even larger budgetary hole than the one faced by the legislature this year. In order to balance the current budget, legislators delayed $115 million in state school aids until the next budget; restructured long-term debt to save $75 million and spent $450 million by selling off the state's share of the tobacco settlement. Those options will not be available to the next governor who may face a structural deficit of one billion dollars or more

How would a Democratic governor deal with a budget crunch of that magnitude?

Will he or she be likely to say no to WEAC's demands for higher education spending and looser cost controls? Or will they opt for "revenue enhancements"?

Again, this year's budget may provide a clue.

Legislative Democrats have already gone on record favoring new taxes on businesses, as well as expansions of existing taxes and the removal of various exemptions. They've also shown a willingness to endorse hidden or indirect taxes on everything from telephones to garbage. Given the pressures to create and expand new revenue sources, it no longer seems inconceivable that a future governor and legislature might remove or significantly cut down on the state's current exemption of machinery and equipment from the property tax. Make no mistake: the M&E exemption is the motherlode for freeing up tax dollars for schools and local governments alike.

Certainly the easiest (and most politically tempting) increase would be on high-income earners. Democrats will not even need to create a new tax bracket, because the GOP did it for them.

The next governor could always further jack up cigarette taxes, but at some point such tax increases will yield diminishing returns.

As it is, the reliance on cigarette taxes may serve to further drive up both spending and general taxes. If, for example, the state's anti-tobacco campaign is effective in getting people to stop smoking, it will also dry up revenue from tobacco taxes, which is being used to fund the new prescription drug benefit for seniors. If that revenue disappears, who imagines that future legislators would scale back the prescription entitlement? Instead, the cost would be shifted onto the general state tax base, further straining an already overloaded budget.

Like the two-thirds school funding commitment, the new prescription drug entitlement is a blank check that will continue to grow regardless of the state's ability to pay.

Reality Check

For both parties, the best case scenario is for the state to grow itself out of its budget problems. A healthy economy would generate additional revenue which could erase the deficit, pay for budgetary goodies, and perhaps obviate the need for more tax hikes.

But the pressure for higher spending and taxes seems to work at cross-purposes with hopes that the state can grow its way out of its current dilemma. Growth requires investment — but a very different kind of "investment" than Burmaster or legislative Democrats are talking about. Recent studies indicate that Wisconsin is experiencing a "brain drain" of talented college graduates who have found better paying jobs elsewhere. In part, the drain reflects the lack of high-paying jobs here, as well as the relative shortage of fast-growing businesses that create such jobs.

Economic growth requires entrepreneurial investment in the private sector, which creates markets, economic activity, and jobs. Such investment requires incentives, opportunities, and rewards. Increasingly Wisconsin seems intent on punishing precisely those elements most required for genuine investment.

As the Wisconsin Taxpayers Alliance points out, Wisconsin lacks the money for innovative start-up companies because it lags behind much of the country in "homegrown income and wealth that can be tapped to start, grow and keep new technology ventures in Wisconsin." Citing IRS statistics, the WTA found that Wisconsin's share of "high-bracket" taxpayers (those with adjusted gross incomes of $200,000 or more) was 25% less than the national average. If Wisconsin's proportion of upper-income taxpayers was the same as the national average, the state's adjusted gross income would be $6 billion higher than it is now.

Not surprisingly, the high-income gap between Wisconsin and the rest of the country is paralleled by a wealth-gap. The WTA found that among individuals with holdings between $600,000 and $10 million, Wisconsin is one of the ten least wealthy states in the country. "Translated into dollars and cents," the WTA concluded, "this means that, if Wisconsin were an average state, it would have $31 billion to $36 billion more in personal wealth than it actually has."

Chuck Chvala — like Democratic Governor Tony Earl in the 1980s — seems tone deaf to the impact of the state's tax climate on investments and job creations. If only, they seem to believe, the state continues to increase spending on education, the economy will pick up. But the well-educated workforce still needs someplace to work; and in an increasingly mobile and competitive society, both capital and brains seek out the friendliest environments.

Higher individual income taxes, higher death taxes, and higher business taxes would be unlikely to act as incentives to attract or retain such wealth or private sector investments. Instead, there is every reason to believe that it is precisely these sorts of individuals who could find themselves in the political cross hairs. All in the name of "investment."