COULD SURPLUS HELP IMPROVE STATE-LOCAL RELATIONS?

With new projections showing the state's bottom line will grow by $2.9 billion over the current two-year budget, lawmakers from both parties are debating how to utilize this newfound windfall. While not yet a prominent part of the discussion, the state's improved fiscal position may create the best opportunity in years to help local governments with their growing challenges – including those posed by a tight labor market and high inflation – and ease longstanding conflicts in the state-local funding relationship.

Our June 2021 report, *A Golden Opportunity for Wisconsin*, discussed the "unprecedented windfall" the state was expecting from a projected massive increase in state tax collections through mid-2023. We laid out several options for using this unexpected revenue, including investments in infrastructure, workforce development, and K-12 education as well as targeted tax cuts and steps to further bolster reserves.

Little did we know that seven months later, new projections from the Legislative Fiscal Bureau (LFB) would show the outlook has grown even rosier. State tax collections for the period covered by the current state budget (July 1, 2021 through June 30, 2023) are now projected to exceed budgeted projections by $2.51 billion, or 6.7%. This is the second time in less than a year that the state has revised its revenue projections upward by billions of dollars (see Figure 1).

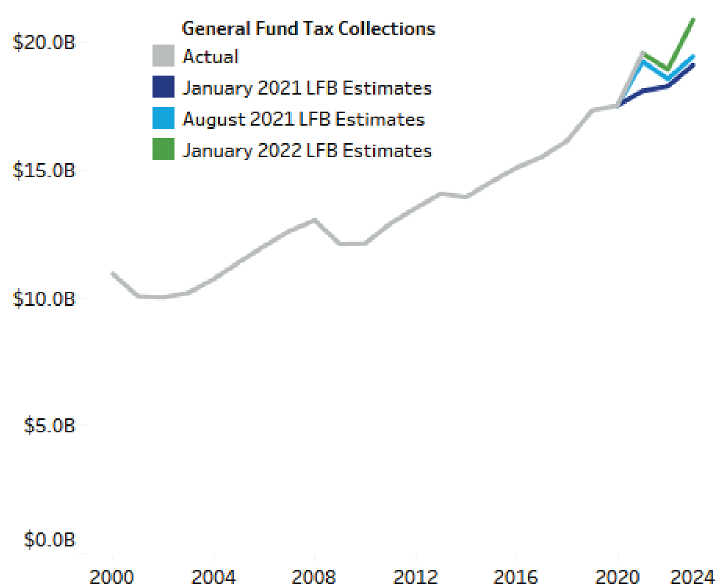
Combined with other newly reported budget developments, this means the state is now projected to enjoy a $3.91 billion gross general fund balance at the end of the biennium. That amount is $2.88 billion more than the already healthy balance projected when the budget was adopted last summer. In addition, the state's rainy day fund is expected to remain at a record high $1.73 billion throughout this budget.

Consequently, state policymakers now face the pleasant dilemma of deciding what actions – if any – should be taken to use some or all of the projected surplus. Some Republican lawmakers have suggested that no action be taken in the current biennium so tax cuts can be considered in the 2023-2025 state budget. Conversely, Gov. Tony Evers has presented a plan that would act this year to give a $150 "surplus refund" to every Wisconsin resident, spend $611 million on K-12 education, and direct $111 million to the University of Wisconsin System, among other uses. The plan also would increase state-imposed limits on revenues school districts can raise from local taxes and state general aid by $200 per pupil in the 2022-23 school year.

In this report, we reflect on our previous research on the escalating financial challenges facing Wisconsin's local governments and note new challenges that may emerge as these governments struggle to retain and recruit key staff in an historically tight labor market and amid high levels of inflation. State leaders might also wish to

Figure 1: Tax Projections Rise Once Again

Actual and projected state general fund tax collections, 2000-2023



Sources: Department of Administration and Legislative Fiscal Bureau consider these local government challenges as they debate a response to their improved fiscal outlook.

WHY THE IMPROVED OUTLOOK?

The bulk of the state's projected financial improvement is attributed to surging tax collections. According to LFB, individual income tax collections are projected to be $823.7 million (4.8%) higher than budgeted, sales tax collections $670.9 (5.0%) higher, and corporate tax collections 935.0 million (23.0%) above initial projections during the two years covered by the budget.

Changes to federal law stemming from the pandemic also are benefiting the budget. LFB cites a projected $339.4 million reduction in budgeted appropriations across all state agencies, with $270 million of that total primarily attributed to an enhanced federal Medicaid matching rate that was adopted early in the pandemic and has remained in place longer than anticipated.

The $3.91 billion general fund balance the state is now expecting at the end of the 2023 fiscal year will be accompanied by a projected rainy day fund balance of $1.73 billion (see Figure 2). The combined $5.64 billion in reserves represents 27.8% of net appropriations of General Purpose Revenue (GPR) – easily the highest percentage in decades.

SHARING THE WEALTH?

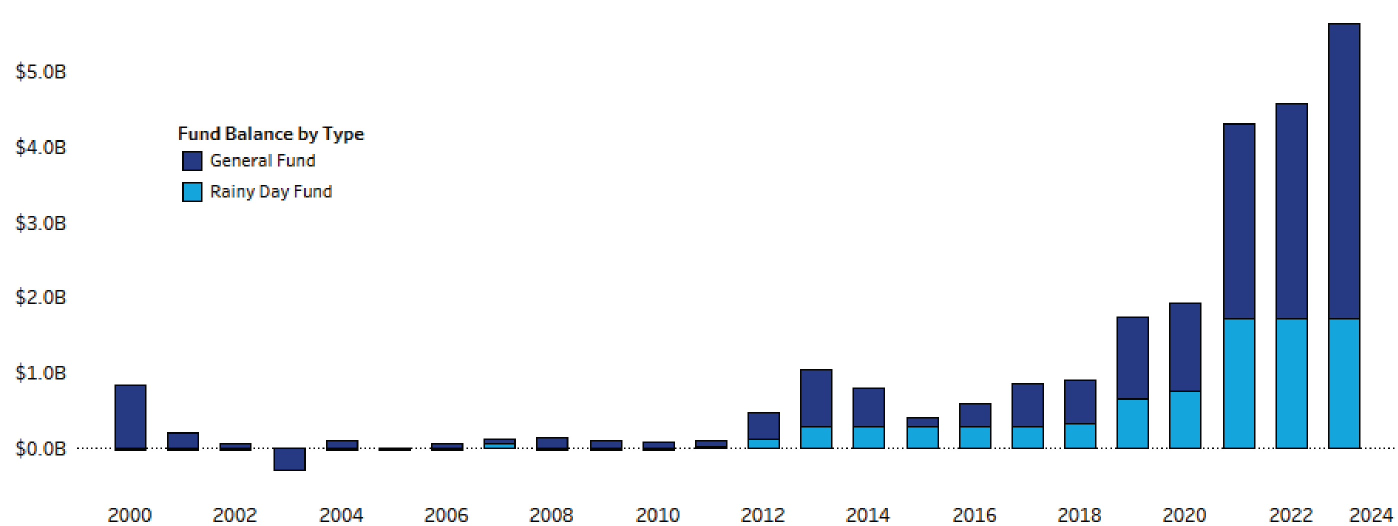
As noted above, legislative leaders and the governor have been putting forward their own ideas for responding to the projected surplus. A main point of contention is whether to give back a portion to taxpayers now while also addressing priorities in areas like K-12 and higher education, or to wait instead until the next state budget and use the surplus to anchor a more comprehensive series of tax cuts and reforms.

Yet, there is another option that has fallen beneath the radar thus far: using some portion of the funds to help address financial challenges faced by municipal and county governments throughout Wisconsin. Those challenges are intensifying as a result of the state's extremely tight labor market and increasing expenditure pressures in areas like public health, human services, and public safety. (The tight labor market – which already has required salary adjustments for certain state government jobs – also should be taken into account by state leaders with regard to the state's own workforce as they consider use of the surplus.)

State policies contributing to local government fiscal challenges have been explored in Forum research and discussed by local government leaders for years. Though WPF does not advocate for specific policy changes, we offer further context below on the two areas of state policy that have generated the fiercest pushback from local leaders. The state's improved fiscal condition might offer an opportunity to at least partially address issues related to critical local government services and, in so doing, alleviate a longstanding point of conflict in the state-local relationship.

Figure 2: Projected State Reserves Keep Climbing

Year-end general and rainy day fund balances (not adjusted for inflation)



Sources: Department of Administration; Legislative Fiscal Bureau; projections for 2022 and 2023 are from January 2022 LFB memo.

State Shared Revenues

In 1911, Wisconsin leaders created the first state income tax in the country. At the same time, they initiated a structure for financing state and local services in Wisconsin that has lasted until this day.

With the enactment of the individual and corporate income taxes, the state also ended the property tax on intangible assets such as stocks, household goods, and farm equipment. Most of the income tax collections were provided in turn to the local governments that under the new law were losing property tax revenues, as well as the opportunity to levy their own income taxes. A similar principle was reflected when the state created only for itself the authority to issue a sales tax in 1962.

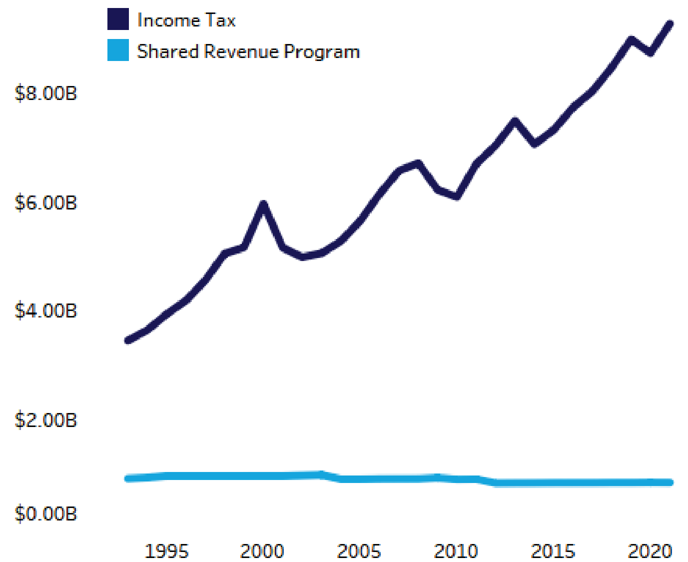
According to an article on the Wisconsin Historical Society website, municipalities initially received 70% of the state income tax collections, counties 20%, and the state 10%. Over time, not only have the percentages paid to local governments dramatically declined, but the concept of "sharing" state tax revenues as they continue to grow has been abandoned. In the meantime, with the exception of a half-cent local sales tax option granted to counties in the early 1990s and a similar option later granted to a handful of municipal "premier resort areas," Wisconsin's local governments have not received permission from the state to levy income or sales taxes.

In our 2019 report, *Dollars and Sense*, we estimated that in 2015, total state aid to municipalities accounted for less than one-sixth of the value of state income taxes. That calculation includes federal aid received by the state and passed along to municipal governments.

Moreover, while state income tax collections have more than tripled since the early 1990s, appropriations for the shared revenue program – which is the primary mechanism for upholding the state's original commitment to redistribute some portion of state income and sales tax collections to local governments – have declined somewhat (see Figure 3).

If inflation is taken into account, the disparity becomes more striking. In fact, if the 1990 shared revenue expenditure of $835.6 million had grown at the pace of the Consumer Price Index (CPI), then it would have totaled $1.73 billion in 2021, or more than double the estimated expenditure of $829.6 million.

Fig 3: Shared Revenues Not Keeping Up with Income Taxes
Total state income tax revenue vs. shared revenue payments to counties and municipalities, 1993-2021



Sources: Legislative Fiscal Bureau, Department of Administration

Levy Limits

The one major tax that local governments have the authority to levy is the property tax. Yet this, too, has seen state-imposed restrictions in recent years – further compounding the financial challenges posed by stagnant shared revenues and a lack of local tax options.

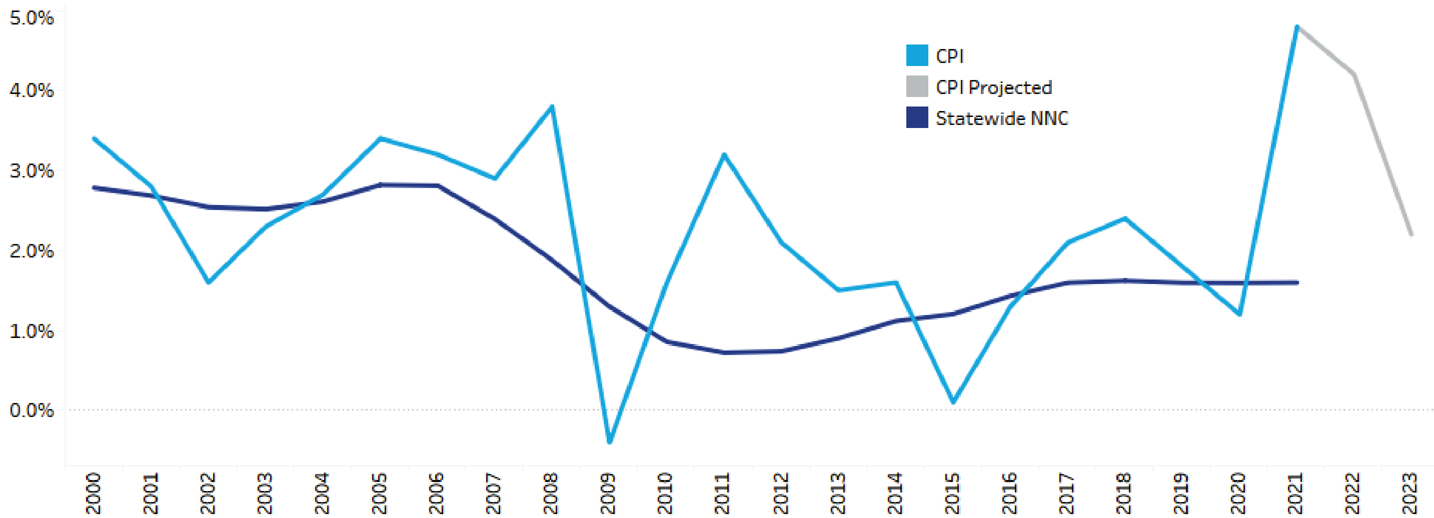
In 2006, the state placed limits on increases in municipal and county property tax levies. The limits initially were linked to the percentage growth in property values due to new construction, but a "floor" was established to allow increases of up to 2% if new construction did not reach that level. The floor varied from 2% to 3.86% between 2006 and 2010. In 2011, the minimums were removed, which in general froze municipal and county property taxes used for operations except for increases due to new construction or voter referenda.

These more restrictive limits came just as many Wisconsin communities saw a slowdown in development. As shown in Figure 4 on the following page, the average annual increase in statewide net new construction has lagged the growth in the CPI in all but two years since 2011, and often by large amounts.

It is also important to recognize that annual local government expenditure pressures in areas like public safety, human services, and employee health care often

Figure 4: Allowable Growth in Levy Rarely Matches CPI

Average annual change in CPI vs. Wisconsin statewide net new construction, 2000-2021



Source: Wisconsin Department of Revenue, Legislative Fiscal Bureau, Federal Reserve Bank of Minneapolis

exceed CPI, making that somewhat of an imprecise mechanism for gauging local government spending needs.

Finally, the statewide average annual growth in net new construction is likely skewed by a small number of fast-growing communities in the state. In fact, in no year since 2011 have more than 22% of Wisconsin's cities and villages seen net new construction grow by more than 2% annually; and in every year during that period, more than two thirds of municipalities grew less than 1.5%.

LOCAL FISCAL PRESSURES GROW

The levy caps and their linkage to net new construction have created very limited capacity for most municipalities and counties to increase their property tax levies to deliver state-mandated services and otherwise respond to local needs. The extent to which this demands a policy response from state lawmakers has generated spirited debate, however.

On the one hand, strict levy limits have produced a huge benefit for property taxpayers, who have seen their property taxes fall from a statewide average of nearly 4% of personal income in 2011 to about 3.3% in 2021. The overall "tax burden" for Wisconsin citizens – which factors in all forms of local, state, and federal taxation – is also now at its lowest point since at least 1970 (see our recent report on the tax burden for more detail).

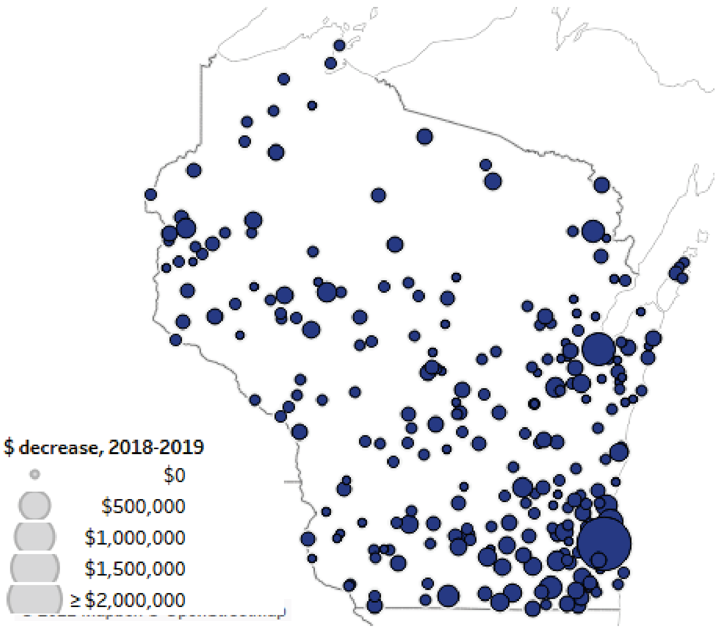
It is also critical to recognize that the adoption of Wisconsin Act 10 in 2011 gave municipal and county policymakers and administrators greater opportunity to reduce personnel costs (or at least keep them in check) in conjunction with the strengthening of levy limits, thus easing financial pressures. Some might also argue that the recent arrival of unprecedented amounts of federal pandemic relief aid has minimized or at least delayed the need to contemplate changes to the current local government financial paradigm (although the federal aid does come with restrictions on allowable expenditures).

Yet, on the other hand, when combined with the lack of growth in shared revenues and absence of revenue alternatives, the strict levy limits on municipalities and counties have placed many in a fiscal vise that has grown tighter with each passing year.

That tightening is reflected by an increase in the number of local governments seeking voter approval to exceed property tax levy limits in recent years. In addition, our recent research has shown there are vital local government service areas that are exhibiting significant signs of stress.

For example, last year we reported that prior to contentious calls for police "defunding" in the summer of 2020, hundreds of municipalities across Wisconsin were cutting police spending and staffing, likely because of fiscal constraints. Specifically, we found that 253 of the state's 1,854 cities, villages, and towns reported decreased spending on law enforcement from 2018 to 2019 (see Figure 5). The same brief found that an even greater number – 621, or about one in every

Figure 5: Hundreds of WI Communities Cut Police Spending
Municipalities with decrease in law enforcement spending, 2018 to 2019



Source: Wisconsin Department of Revenue

three – reduced spending on fire protection services that year.

In another 2021 report summarizing insights gleaned from our fire and emergency medical services (EMS) studies in dozens of communities across Wisconsin, we cited the growing number that are struggling to maintain sufficient part-time staffing rosters and the resulting negative impacts on response times. While several factors contribute to this challenge, the lack of sufficient local government financial capacity to boost pay for responders and transition to full-time staffing models is paramount.

CONCLUSION

Increased state aids and relaxed state levy limits are not the only potential mechanisms to address local government financial challenges in Wisconsin. For example, our own research has suggested there is considerable opportunity to reduce costs and improve service levels by consolidating certain governmental functions among groups of municipalities or between municipalities and counties.

However, after more than a decade of struggling with a combination of tight levy limits and stagnant state aids, it is certainly questionable whether many local governments will be able to stave off service cuts without some relief from the state once federal relief funds are exhausted and should nothing else change.

The future is even more alarming given statewide worker shortages and rising inflation. That double whammy will require many local governments to consider adjusting their compensation structures to attract and retain the skilled workers they need.

There would be many options for state leaders if they wish to use a portion of the projected surplus to help local governments in the next state budget. Those include obvious strategies like increasing the shared revenue appropriation and tying it to inflation, as well as narrower approaches aimed at shoring up specific services, like increasing reimbursement for EMS ambulance transports or non-transport responses.

Reconsidering levy limits also may be an option, either in general or to exempt specific services, such as those that rely on difficult-to-recruit workers. In this case, the impetus would not be the state's growing fund balance, but a recognition that more should be done to help local governments respond to inflationary pressures. One option would be to link levy limits to a metric (like CPI) that is more closely tied to the growth in their costs than net new construction. This might also be seen as a matter of fairness given the state's enjoyment of such substantial growth in its own major revenue sources.

Warnings of flaws in the state's approach to financing local governments have been issued for decades, even prompting creation of a governor-appointed blue ribbon commission (the Kettl Commission) to study and address them in 1999. Yet, despite those warnings and growing strain in state-local relations, little has changed on the policy front, in part because the state's own financial challenges have precluded it from doing so.

The state's unprecedented fund balances and surging tax collections may now offer the best opportunity in decades to reconsider the local government revenue structure and ensure appropriate capacity for the delivery of vital services by county and municipal governments across Wisconsin.