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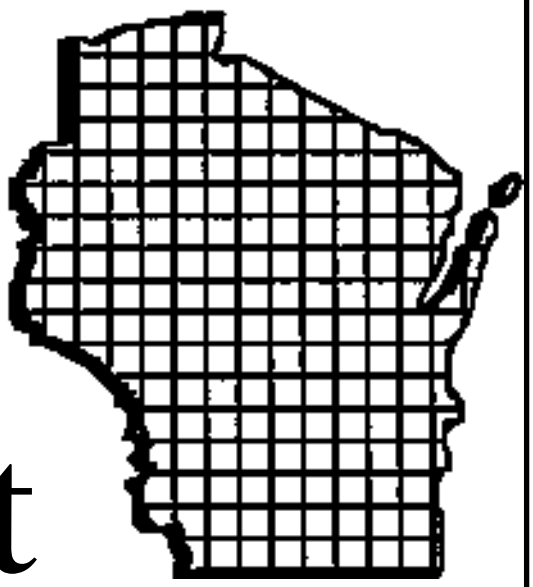


December 2004 Volume 17, Number 8

Raising the Sales Tax to Lower the Property Tax

A Flawed Idea for Schools and for Taxpayers

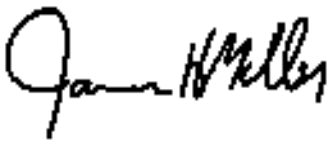
REPORT FROM THE PRESIDENT:

Whenever Wisconsin elitists talk about restructuring state tax policies, the first thought that comes to mind is "take a firm hold on your wallet." Earlier this year, a task force appointed by Governor Doyle proposed raising Wisconsin's sales tax by 20% in order to lower our property taxes. This recommendation, which has been proposed in the past by liberals in Madison, is one that we took quite seriously. We asked our senior fellow, George Lightbourn, former Secretary of Administration, to examine this proposal. He had assistance from a young economist, Jason Kohout, a current Harvard law student, who has done economic research on Wisconsin's educational system.

Their examination of these proposals points to the astonishing presumption that Wisconsin taxpayers would do better relying on raising the sales tax to supposedly lower property taxes. Of course, after seeing the unpredictable accuracy of Wisconsin's revenue projections over the last several years, the thought that the sales tax could continuously provide stable revenue in the future is almost laughable. This is also the usual rhetoric that education is under-funded and needs ever-increasing revenues. Unfortunately, this particular task force doesn't bother to address the real financial problems facing school districts across Wisconsin. These current problems have very little to do with providing additional money for classroom instruction. Instead, they stem from the explosion in fringe benefit costs over the last several years. These costs were not even dealt with by this commission. Why would they want to offend the teachers' union, whose labor agreements are one of the major reasons for the current fiscal plight of so many school districts across the state?

We assume that the Legislature and the governor will ignore these recommendations. If there is one message that has been sent loud and clear from Wisconsin taxpayers to Madison, it is that they pay too many taxes for too many government services, and they have no tolerance for further tax increases.

Educational funding is a legitimate issue in this state; raising taxes isn't. Because we need to spend our educational dollars wisely, we must restructure funding so that tax dollars go toward direct teaching in the classroom and not to labor contracts that have gotten totally out of control.



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Raising the Sales Tax to Lower the Property Tax

A Flawed Idea for Schools and for Taxpayers

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EXECUTIVE SUMMARY

A high-powered task force appointed by Governor Doyle is pushing the Governor and the Legislature to increase Wisconsin's sales tax by 20% and extend the tax to many goods and services that are currently tax-free. The $1.5 billion of new state taxes would be spent on increased school aids and thus reduce the property tax. The tax swap is based on the faulty premise that it would be good for education. This report shows that it would be bad for education and bad for an already anemic state budget.

Only last year the Governor and the Legislature were forced to recognize fiscal reality and erase the statutory requirement to fund 67% of local school costs. Now Governor Doyle's Task Force on Educational Excellence suggests that the state increase its share of school costs to 77%. Is this level sustainable or advisable? This report finds the answer to be no. It found state revenues to be volatile, making it almost certain that, at some point, state tax growth will fall short of school spending growth. When that happens, local schools will be hit with double-digit property tax increases and significant budget cuts.

The timing of the recommendation to increase school aids is curious. It is as though Wisconsin's state budget is healthy. However, the reality is different. Schools across the state are experiencing the effects of a mismatch between state tax collections and state spending commitments. School superintendents and school boards across the state are struggling to deal with state funding that has declined just slightly from 66.67% of cost to 65.1% of cost. This seemingly small backtrack from the 2/3 commitment has hit schools hard. For example, the reduction in the state commitment forced Milwaukee Public Schools to increase the school property tax levy by 13.2% and to cut teaching staff.

The Task Force report goes to great lengths to tout a 42.8% reduction in school property taxes that would result from the proposed sales tax increase. However, any such reduction would be temporary at best. A review of state tax collections reveals a volatility that has yielded 10% growth in revenues one year, only to be followed by a year of negative growth. Moving more of school costs onto state aids will increasingly expose schools to this volatility. It is inevitable that the economic cycle will eventually soften again, and the state government will no longer have the level of tax collections needed to maintain its commitment to school aids. The ensuing retrenchment will mean substantial property tax hikes and budget cuts for local school boards, similar to what they are experiencing today.

This report includes a model of the interplay between state tax collections and school finance. The model shows that, under the Task Force recommendation, only if the growth of state tax collections remains in the 5% range will property taxes moderate. The model demonstrates that, at the first sign of softening state tax collections, local property taxes will rise dramatically. If state revenues grow at only 2% annually, rather than 5%, homeowners should expect to see school property taxes rise by 12%.

Also of concern is the degree to which the Task Force recommendation would increase the overweighting of the state budget toward school aids. The Task Force recommendation would render school aids more than half of the state budget. As recently as 1990, school-aid funding accounted for just 27% of state spending. Since then the share of the budget devoted to school aids has been on the increase. School aids are already pinching the ability for state government to address other needs such as demands for spending increases as well as tax cuts. The Task Force recommendations would exacerbate this phenomenon.

The Governor and the Legislature should reject the Task Force recommendation to increase the sales tax. Instead they would do well to focus more directly on the factors that drive local property taxes. The notion of increasing state taxes to buy property tax relief cannot work. Further, the Governor and the Legislature should be encouraged to enhance the stability of the state budget, for only with a stabilized state budget can state government assure local property taxpayers and school administrators that the current state commitment to schools will be maintained.

INTRODUCTION

The funding of K-12 education is one of the most discussed yet least understood public policy issues facing Wisconsin. Through time governors, legislatures and superintendents of Public Instruction have grappled with issues that spring from the constitutional provision that assigns responsibility for education to state government. When the issue intensifies, policy leaders have sought out the advice of committees of citizens about how the state can best meet its obligation to fund education.

Governor Doyle appointed the most recent group of citizens to examine education funding issues. This past summer the Governor's Task Force on Education Excellence issued a report that has the potential of significantly reshaping how Wisconsin schools are funded. The Task Force surprised most observers and eschewed the opportunity to consider rewriting the formula used to distribute school aids. Instead, the Task Force focused on moving a greater share of school funding to state-collected taxes. The Task Force settled on a radical set of recommendations to increase the state sales tax and use the proceeds to lower the local school property tax.

The notion of substituting one tax for another is hardly new. As recently as the mid 1990s Wisconsin sought to lower local school property taxes through state-collected revenue. In 1997, the Governor and the Legislature added $1 billion to school aids, which lowered school property tax levies by 16%. However, the added funding was made possible through a windfall of state revenues resulting from a robust economy. The Task Force is asking the Governor and the Legislature to tackle the issue head-on by voting to raise the sales tax to make the tax swap possible.

A potential sales tax increase is usually rationalized, as it was in the Task Force report, by comparing the sales tax in Wisconsin to other states. The report noted that Wisconsin has the lowest sales tax rate in the upper Midwest. Usually lurking close by is the sense that the sales tax is attractive to some people because it is collected in small, almost invisible, installments rather than the more noticeable annual property tax bill.

However, just below the surface of the seemingly simple tax swap are several important policy issues, none of which were addressed in the Task Force report. These include tax incidence (which taxpayers benefit from the swap and which are injured), the impact on the distribution of school aids (which districts win and which lose), and what will be the ultimate impact on the ability of schools to meet the needs of Wisconsin students.

Frankly, it is easy to oversimplify the impact a higher level of school aids would have. By portraying the swap between property tax and sales tax as a simple one-for-one transaction, the analysis implicitly makes certain assumptions: it assumes that the mix of spending in the state budget will remain static; it assumes that state revenues would be able to continue to support the higher level of school aids into the future. Further, it implies that the reduction in property taxes would be lasting.

This report will more closely examine the key components that will determine whether these assumptions are valid and whether the recommendations of the Task Force will deliver real and lasting property tax relief. This analysis is intended to assist policymakers who might be intrigued by the notion of buying a property tax cut with an increase in another tax.

While this report focuses on the specific Task Force report that is currently before the Governor and the Legislature, the significance of this analysis rests less on the specifics of that particular report and more on its analysis of the impact of significantly increasing state funding of local schools.

BACKGROUND

School Finance Committees through History

Governor Doyle's 2004 Task Force on Education Excellence is the most recent example of a public policy debate that dates into the early recesses of the twentieth century. Since the state's responsibility for schools rests in the Constitution, the debate has never focused on *whether* state funds should help pay for schools but on the adequacy of funds and the fairness of school finance; does the system of funding schools support good education in all school districts?

For example, a 1924 report issued by the Department of Public Instruction challenged the dollar-per-student allocation formula that existed at that time.[1] Their report found "indisputable evidence that the present method of dis-

tributing our school fund does not furnish adequate financial support for all the common school districts of the state without excessive taxation in the poorer districts."[2] As a result of that report, state statutes were changed to introduce tax base equalization into the formula for distributing school aids.

Two decades later, a 1946 study commission spent two years examining school funding. It was driven primarily by concern for the increasing burden schools were exacting on the property tax. At the time, state funds covered only 22% of school costs. After two years of study the Legislature changed the law by increasing state aids and greatly enhancing the equalizing features of the distribution formula. According to Jack Stark in his writing for the Wisconsin Blue Book, "This act expressed the state's intention, by means of school aid, to provide property tax relief and to equalize educational opportunities."

2004 Task Force

In 2004, Governor Doyle's Task Force on Educational Excellence issued the most recent in the long lineage of studies on education funding. This report was somewhat different from its predecessors in that the focus was not on the fairness of the distribution formula. Instead, the Task Force worked from a broader view of education. It found that, while Wisconsin has a history of a strong K-12 system, Wisconsin's educational quality is being threatened. The state education system faces challenges stemming from changing demographics and greater demands from employers.

With respect to education finance the report's focus was less on the specific variables used to distribute state aids and more on the overall balance between state and local funding. The report dwells on the unpopular nature of the property tax and its effect on education. It notes that:

> [P]roperty taxes can create a dangerous tension between the shared goals of high quality public schools and taxpayers' ability to pay. Taxpayer support for efforts to improve education may be undermined by the calculus of their direct effect on their own property tax bills.

The Task Force report noted a concern with both the popularity and the stability of the property tax as a funding source for education. The report implies that a property tax-based system for funding education is a dated concept. The report was especially concerned about the drop in the percent of homes with children. Fewer Wisconsin homeowners experience direct benefits from K-12 schools, adding a destructive tension between property taxes and education. The report established the underpinning of its key recommendation by finding: "It is time to pull our kids out of the property tax wars."

How would they pull kids out of the property tax wars? They recommended raising Wisconsin's sales tax from 5% to 6% and eliminating a number of exemptions to the sales tax. These tax increases would generate an additional $1.55 billion per year to the state treasury. The Task Force recommended using $1.4 billion of the funds to increase school aids and the additional $110 million to simply increase school spending. The additional school aids would be used to cut local school property taxes by an average of 42.8%, as shown in Table 1.

TABLE 1 SALES TAX SUBSTITUTION FOR PROPERTY TAX

Increased State Revenue Collection	
Sales tax increase from 5% to 6%	$800 million
Eliminate unspecified sales tax exemptions	$640 million
Total new state revenue	$1,440 million
Lower Local School Property Taxes	
Current local school property tax	$3,360 million
Offset from additional school aids	$1,440 million
Net school property tax reduction	42.8%

Source: Task Force on Educational Excellence

The tensions identified by the Task Force are not new. They have existed for decades. However, the tensions are exacerbated when public funds are in short supply. Since the recession of 2001, state education funding has been threatened, a threat that finally materialized when the Governor signed the 2003-05 biennial budget into law. That budget rescinded the state's statutory obligation to provide 2/3 of the funding for Wisconsin schools. This pushed an increased burden onto the local property tax.

It is unmistakable that, if the recommendations of the Task Force become law, the funding of education will be profoundly affected. Some of the effects include:

- The state share of school cost would rise from 63% to 77%.
- Wisconsin would move from 18th to 3rd in the state share of school spending.
- School property taxes would experience a one-year decline averaging 42.8%. Since schools represent 42% of local property taxes, the overall average reduction in the property tax levy would be 20%.[3]
- Wisconsin's sales tax would be increased by 20% on goods and services to which the sales tax currently applies. Other goods and services currently exempt would see the full (100%) impact of the recommended 6% sales tax.
- School aids would account for more than 50% of the state budget.

Subsequent sections of the report will address whether the Task Force recommendations are likely to lessen the tensions between schools and property taxpayers. More important, some sections will explore the question, "if the tensions are reduced will the change be lasting?"

The Context for Considering Increased School Aids

Wisconsin spends $8.1 billion[4] on K-12 education, making it the largest public expenditure in Wisconsin. As such, school funding drives much of the discussion of spending and taxes in Wisconsin. Historically, attempts to mitigate the impact of schools on local property taxes have proven temporary at best. The Task Force's property tax relief promises are not significantly different.

This report will analyze the impact the recommendation would have on the state budget and the sustainability of the increased state funding. After all, still fresh in the memories of policymakers in Madison should be the weight of the burden of the requirement to fund 67% of school costs. The 2/3 funding commitment, popular in the mid 1990s, proved to be unsustainable. A number of policy questions will be addressed in the balance of this report:

- Would the move to increase the state share to 77% (albeit supplemented by the increased sales tax revenues) run the risk of similarly burdening future Legislatures?
- What would be the impact on the state budget's ability to accommodate other spending demands? An equally important question runs to the sustainability of the elevated state share.
- As the funding of local schools becomes increasingly dependent on state funding, what is the likelihood that state revenue collections will sustain the higher level of state aid?
- What will be the impact if the state cannot maintain the higher level of support for local schools?

Before analyzing the impact of increasing the sales tax to provide property tax reductions, it is useful to provide a base of information on both education spending and the state budget. These are the two systems that will be affected by the change.

K-12 Spending in Wisconsin

Wisconsin spends well above average to support its K-12 system. Data collected by the U.S. Census Bureau shows that Wisconsin is spending $8,574 per pupil, which is 11.3% above the U.S. average spending of $7,701 per pupil.[5]

Wisconsin's willingness to spend on K-12 education is not a recent phenomenon. Todd Barry and Dale Knapp made a detailed analysis of Wisconsin's historical spending for state and local government.[6] Their study reveals that Wisconsin has historically been willing to spend above average for government. They note that Wisconsin's spending has been above average among the states since 1951. They documented that, by 2000, Wisconsin's state and local spending had reached a point 7.4% above average.

The largest reason for Wisconsin's high spending is its spending on K-12 education. Their study noted some of the key factors causing education spending to be high relative to other states: fringe benefits well above average, slightly higher than average salaries, and a lower ratio of students to teachers. Table 2 shows how Wisconsin compares to the U.S. average based on 2001-02 Census data.

TABLE 2 PER PUPIL SPENDING - WISCONSIN COMPARED TO U.S. AVERAGE, 2001-02

	Wisconsin	U.S. Average	% Difference
Total Spending	$8,574	$7,701	(11.3%)
Instruction Salaries	$3,535	$3,407	(3.7%)
Benefits	$1,397	$884	(58.0%)

Source:: U.S. Census Bureau, Public Elementary-Secondary Education Finance Data, 2002
Available at: http://www.census.gov/govs/www/school.html

In recent years Wisconsin's overall spending on K-12 is creeping closer to the U.S. average. In 2000, Wisconsin's spending was 12.9% above average, a gap that had declined to 11.3% in 2002. It is likely that this reflects the more restrained spending in Wisconsin since the advent of revenue caps in 1996, which will be discussed below.

Special mention should be made of the interplay between salaries and benefits. Under the provisions of the qualified economic offer (QEO) in Wisconsin law, the combination of salaries and benefits is limited (to a 3.8% increase in most school districts). In most districts teachers have opted to continue full funding of their benefits while accepting lower salary increases. While this trade-off has constrained salaries, it has also yielded fringe benefit spending on teachers that ranks Wisconsin second highest nationally, trailing only New York.[7]

Table 3 shows the average spending of state and local taxes per student as used to calculate K-12 school aids for the period of 1993-94 through school year 2002-03.[8] As noted earlier, during this period school spending was restrained by state imposed revenue caps.

TABLE 3 STATEWIDE AVERAGE K-12 SPENDING PER STUDENT, 1994 THROUGH 2003

State Fiscal Year	Spending Per Student	Annual Increase
1994	$6,549	
1995	6,796	3.7%
1996	7,068	4.0%
1997	7,447	5.3%
1998	7,874	5.3%
1999	8,244	5.0%
2000	8,585	4.1%
2001	8,982	4.6%
2002	9,493	5.6%
2003	10,006*	5.4%

* unaudited
Source: Legislative Fiscal Bureau Informational paper on Elementary and Secondary School Aids, January 2003.

SCHOOL FUNDING: SPLIT BETWEEN STATE AND LOCAL SHARE

Wisconsin has had a century-long discussion of school finance fairness. In spite of the advent of high-speed data analysis and a number of court cases, the current discussion of school finance is not materially different from the discussion that took place early in the twentieth century. A system funded primarily through taxes on property favors property wealthy districts over those with lower property values. State aids have historically been used to equalize the capacity of all districts to fund education.

That simple notion of tax base equalization has added immense complexity to the school finance discussion. What was once a simple per student allocation has become a complex maze of factors and weightings. The description of the school aid formula consumes a full six pages in the forty-five page informational paper on K-12 funding prepared for legislators. The complete list of complexities is a long one. What has become very clear is that, with respect to school finance, decisions made in Madison are at least as important as the decisions made in local school districts.

No issue has been as closely watched or as dynamic as school finance. The specific school finance issue that has resonated with the elected officials in Wisconsin state government is how to minimize the burden placed on the local property tax. Within the past fourteen years state government has taken several tangible steps to control local school property taxes. Below is a summary of the four distinct phases school finance has undergone in that fourteen-year period.

Phase I: Pre-1993

In the period before 1993 all spending decisions rested with local school boards. The amount appropriated for state aids was allowed to float and was dependent on what the Governor and the Legislature were able to appropriate in any given year. Each budget the Governor and the Legislature approved contained significant increases in school aids in an attempt to keep pace with school spending. However, in the five years leading up to 1993, in spite of a 7% average increase in state aids, state funding couldn't keep pace with rapidly escalating school spending. As a result, in that five-year period annual increases in local levies averaged 9%.

State policymakers realized changes would be required to bring local property taxes under control. Buying property tax relief by increasing state aids was not working. Phase I was marked by significant annual increases in school spending and significant increases in local property tax levies.

Phase II: 1994-1996

Phase II grew out of frustration with significant increases in local levies. In order to control the levy increases state lawmakers took the extraordinary step of statutorily limiting school spending increases. The amount of spending in schools was limited to growth in the consumer price index with some accommodation made for consolidations and changes in the number of students and additional spending approved by local voters. During Phase II the increase in school spending was dampened and, as a result, local school property tax levies were brought under control. Conceptually, the significance was that school spending decisions were increasingly moving away from local school boards and were being dictated in Madison.

Phase III: 1997-2003

The 1995-97 biennial budget was a watershed event for educational finance. The Governor and the Legislature took two extraordinary actions. First, they extended the controls over school spending to limit not just overall spending, but to also control the amount that school districts could provide for teachers' compensation. This latter provision, referred to as the QEO (qualified economic offer), remains controversial among teachers. The second move by state government was to appropriate an additional $1 billion of school aids. This increased the state share of local school costs from approximately 52.8% in 1996 to 66.67% in 1997. Further, a statutory provision was enacted to require that the state share of school costs remain at 66.67% in future years. The impact of the change was dramatic. From 1995-96 to 1996-97, the school property tax levy was reduced by 23.8%. After the initial decline, levy increases moderated. It seemed that the policy objectives of spending equity and local property tax stability had been achieved. Wisconsin had achieved a steady-state in educational finance.

Phase IV: Post 2003

As state revenue collections slowed in the early 2000s state government found it increasingly difficult to maintain the commitment to fund 66.67% of school costs. This moved school finance into phase IV. In 2003, state statutes were once again changed to remove the requirement that state funding cover 66.67% of school costs. Rather than appropriating the $462 million required to meet the 2/3 requirement, the final budget included an addition of only $112 million. This $350 million shortfall meant that in 2004 school year, the state share fell to 65.1%. Another decline to approximately 63% is expected for the 2005 school year.

Soft state revenue collections forced an additional burden onto local school boards. School districts are faced with either increasing the local levy to accommodate the shortfall in state aid, or reducing spending below what state statutes allow. Many districts have had to do both. Stories of double digit levy increases and a reduction in teaching staff are becoming more common. After six years of relative calm and stability, school finance is once again a contentious issue. This is largely due to the inability of state revenues to keep pace with school spending increases, even during a period when local school spending has been capped under state law.

The Impact of State Aid Shortfall on Local Schools: Milwaukee Public Schools

Milwaukee Public Schools (MPS) is not only Wisconsin's largest school district, it is one facing significant challenges. It is a school district beset with a high incidence of poverty[9], high truancy and dropout rates[10] and generally low performance on standardized tests.[11]

MPS is heavily reliant on state aid. In 2003-04 the district was the second most reliant on state aid, as measured by the percent of the state aid sent to the district. In 2003-04 state aid to MPS totaled $729 million, which accounted for 85% of the district's revenues from state aid and local taxes, well above the state average of 66.67%. MPS' higher share reflects relatively low property valuations and certain categorical aids directed to highly needy Milwaukee students. The funding allocated to integration busing would be an example of this latter factor.

It is speculative for any school district to anticipate specific amounts a school district should receive in state aid. However, past years' state-imposed revenue caps on spending and a fixed 66.67% statewide funding made the funding relationship somewhat more predictable. Superintendent Andrekopoulos, in presenting his budget for the 2004-05 school year, noted that under 2/3 funding from the state MPS would have expected to see a $16 million increase in state aids. However, due to the state rescinding its 2/3 funding commitment, MPS actually saw a $4 million *decrease* in its state aid.[12] For MPS state aid fell $20 million short of expectations.

The impact was dramatic. The school district found itself needing to eliminate 450 jobs, 300 of which are teaching positions. Further, the district experienced a substantial impact on the local property tax levy. The budget introduced by the Superintendent and approved by the MPS School Board will result in a 15.4% increase in the levy (more recently revised downward to a 13.2% increase).

Local school budgets are complex instruments with many moving parts. The MPS estimate that the district realized a $20 million drop in state aid seems to be a reasonable estimate. Had the state fulfilled its statutory commitment to 2/3 funding, it is almost assured that MPS would have more teachers to deal with the students in the system and that the homeowners and businesses in Milwaukee would experience less of a bite when their property tax bills arrive in December.

This exemplifies the double-edged nature of state aid. There are two perspectives of state aid to K-12 schools. One is the short-term perspective that sees additional state aid as means to minimize the property tax levy increase or as a way to add teaching staff or other educational enhancements. This is the perspective behind most of the push for additional school aids.

The longer-term perspective is one that recognizes and anticipates state funding falling short of expectations. The day of below-average state revenue growth is inevitable. That day came last spring for MPS and dozens of other school districts. For years, school districts had prepared budgets that adhered to the revenue caps mandated by state law. However, to continue to produce budgets with moderate property tax levy increases, school districts depended on funding levels required in state statutes. However, in 2003 the Governor and the Legislature were forced to rescind their funding obligation in light of the fiscal realities facing the state budget.

The longer-term perspective is generally lacking in most discussions of educational finance. It was absent in the Task Force report. The balance of this report will take this longer-term perspective in reviewing the Task Force recommendation on the swap of property taxes for sales taxes.

State Budget Allocations for Major Spending Programs

Another subtle but significant consequence of increasing the state funding of school aids entails the ability of future policymakers to make policy. As in every state, the Wisconsin budget is the major policy instrument of state government. No other bill garners the undivided attention of the Governor, the Legislature and the public. When ana-

lysts look to how the actions of state government are likely to impact the lives of the citizenry, they look first to the state budget.

While the Wisconsin state budget includes literally hundreds of policy elements, since the mid 1990s it has been an instrument that has tilted increasingly toward the funding of local school aids. Table 4 shows the repositioning of budget dollars since 1990. In that year school aids consumed 27.8% of state general revenue. By 2003 that share had grown significantly to account for 41.3% of the budget. Not surprisingly, the mirror image of the growth in the share of dollars going to school aids has been the decline in the share allocated to all other major funding categories with the lone exception of the Department of Corrections.

TABLE 4 THE ALLOCATION OF STATE BUDGET DOLLARS PERCENT ALLOCATED TO MAJOR SPENDING CATEGORIES 1990 COMPARED TO 2003

Spending Category	1989-90	2002-03
K-12 School Aids	27.8%	41.3%
University of Wisconsin	11.9%	9.3%
Shared Revenue	13.9%	8.9% *
Property Tax Credits	5.5%	4.1%
Medical Assistance	10.0%	9.3%
Corrections	3.0%	6.5%
Community Aids	3.1%	1.6%
Income Maintenance	2.7%	1.6%

* This percent is based on 2001-02 amounts. In 2002-03 a substantial amount of revenue from tobacco securitization was used to fund shared revenues.

Source: Wisconsin Department of Administration

As previously noted, in the mid 1990s, state policy makers, responding to rapidly escalating local school levies, made a very public and explicit decision to substantially increase the funding of school aids. However, no such explicit decision was made to de-emphasize the importance of other state-funded programs. Yet that is precisely what has occurred. As state revenues have waned, the commitment to support the 2/3 funding of local school costs became increasingly challenging. As a result, other policy objectives have been pinched. The statutory commitment to school aids has crowded out an ability to pursue other policy objectives. Over time, the result has been significant.

For example, had the share of the budget devoted to school aids remained at 27.8% where it stood in 1990, state aids in 2003 would have only been $3.1 billion. This is $1.5 billion less than the $4.6 billion actually spent on local school aids. Where might that additional revenue have been spent? Had the share of the budget applied to other policy goals remained constant, funding for the UW system would have been $260 million, or 25% above where it stood in 2003. Shared revenue payments to cities, villages and towns would have been $530 million or 52% above where it stood in 2003. Many other major spending categories were similarly affected, with the notable exception of corrections which experienced considerable growth.

Of course, budgets are not static documents. New issues emerge and priorities shift over time, as government adapts its funding allocation to meet changing circumstances. Shifts should be expected. However, when a single policy objective overwhelms all others, government budgets are limited in their capacity to respond to changing needs. As noted earlier in this report, the recommendation from the Task Force on Educational Excellence would increase the share of the budget devoted to school aids from 43% in 2004 to approximately 50% in 2006, the first year of the next biennium. For future governors and legislatures, such a lofty commitment to one policy initiative will constrain the ability to respond to other policy objectives, including new spending initiatives, general government property tax relief and general tax cuts. It will also make it more challenging for policymakers to create reserves and to put money into the budget stabilization funds, two moves that will yield long-term fiscal stability.

STATE AND LOCAL REVENUES

The Task Force recommendation would change the revenue base that supports K-12 schools by substituting $1.44 billion from the state-collected sales tax for $1.44 billion of local property tax revenue. The change would affect 17% of the overall funding base for education.[13] With a change of this magnitude, it is critical to understand the relative volatility of the revenue streams. If the revenue stream supporting schools is made more volatile, it would be expected that, at some point revenue growth will be limited, and it will become difficult to maintain a commitment to funding education.

State Tax Collections

Examining the volatility of tax collections is a relevant and timely discussion since state governments across the nation are only now beginning to rebound from the stress of the nationwide economic sluggishness earlier in the decade. No fewer than forty states were forced to make significant budget cuts.[14] Most state governments are reluctant to assume added responsibilities with the pain of budget cuts still fresh, though all struggle with how to deal with pent up demand for new and expanded spending. But in Wisconsin the Task Force has generated a major policy discussion because of their recommendation to greatly increase state funding of K-12 education.

TABLE 5: ANNUAL COLLECTIONS FOR INCOME, SALES, CORPORATE AND OTHER STATE TAX COLLECTIONS (IN MILLIONS)

Year	Sales Tax	Income Tax	Corporate Income Tax	Other Taxes	Total	% Growth
1989-90	1,983.83	2,624.90	436.60	604.30	5,649.63	
1990-91	2,026.68	3,003.40	440.90	601.90	6,072.88	7.49%
1991-92	2,127.32	3,142.21	437.69	632.20	6,339.42	4.39%
1992-93	2,260.56	3,445.83	492.02	672.60	6,871.01	8.39%
1993-94	2,427.90	3,638.71	541.28	679.60	7,287.49	6.06%
1994-95	2,571.21	3,932.95	631.75	671.00	7,806.91	7.13%
1995-96	2,704.23	4,183.60	636.01	711.90	8,235.74	5.49%
1996-97	2,864.37	4,558.26	643.82	751.10	8,817.55	7.06%
1997-98	3,047.41	5,047.51	627.02	806.60	9,528.54	8.06%
1998-99	3,284.70	5,162.24	635.20	866.20	9,948.34	4.41%
1999-00	3,501.70	5,962.01	644.63	837.70	10,946.04	10.03%
2000-01	3,609.90	5,156.57	537.16	739.82	10,043.45	-8.25%
2001-02	3,695.80	4,979.66	503.01	841.72	10,020.19	-0.23%
2002-03	3,737.91	5052.50	526.00	882.60	10,199.01	1.78%
2003-04*	3,900.00	5,220.00	650.00	900.40	10,670.40	4.62%
2004-05*	4,095.00	5,560.00	630.00	910.80	11,195.80	4.92%

* Estimated

Table 5 shows state tax collections between 1990 and 2004. The last two years are based on estimated collections. Over that period state tax collections grew by 91% and would have doubled were it not for tax cuts enacted in 1999.[15] The average annual increase in collections was 4.8%. It might be tempting to use this average as a proxy for future revenue growth. However, this average increase belies a good deal of volatility in collections.

The 1990s were a particularly robust period for state tax collections. As the economy realized substantial growth, so too did state revenues experience nearly unprecedented growth. However, the close of the decade brought with it a reduction in state income tax rates as well as a mild recession. The combination of the two factors yielded revenue growth substantially below what was experienced in the latter part of the 1990s. As shown in Table 5, in the three-year period between 2001 and 2003 state revenues fell off considerably.

The volatility of state tax collections can be expressed as a standard deviation; the lower the standard deviation, the less volatility is found in the collections. The volatility of actual collections is 0.04437. If the impact of the tax cuts enacted in 1999 is filtered out, the volatility is reduced to 0.03294. By either measure state tax collections are shown to be rather volatile.[16]

As an aside, it is this volatility that is largely responsible for the fiscal stress that faced most states early in this decade. Spending decisions in state governments tend to be based on short-term forecasts of revenues. So, even though the economic cycles of growth and contraction are normal aspects of state finance, it has been difficult for states to anticipate economic downturns and to react to downturns when they occur. One might conclude that it seems that most state governments, including Wisconsin, make spending decisions as though they expect downturns never to occur. This observation should be clearly understood when analyzing the prospect of moving more of the responsibility for education finance to state government and its volatile revenues.

Local Tax Collections

It is interesting to contrast the volatility of state tax collections with the relative stability of the underlying value for local government taxes, the equalized valuation of property.[17] Table 6 shows the annual growth in property valuation between 1990 and 2004. It is notable that over that period there was not a year in which statewide property valuation declined. The average annual increase in property valuation during that period was 7.5%, significantly higher than the 4.8% average for state tax collections during this period.

TABLE 6 PROPERTY EQUALIZED VALUATION AND STATE TAX COLLECTIONS, (IN MILLIONS)

	Total Property Valuation	Change	State Tax Collections	Change	% Property Value Increase -% State Tax Increase
1989-90	133,206.1846	*******	5,649.63	*******	******
1990-91	141,370.3072	6.13%	6,072.88	7.49%	-1.36%
1991-92	150,927.7562	6.76%	6,339.42	4.39%	2.37%
1992-93	159,587.0032	5.74%	6,871.01	8.39%	-2.65%
1993-94	171,677.1635	7.58%	7,287.49	6.06%	1.51%
1994-95	184,994.8661	7.76%	7,806.91	7.13%	0.63%
1995-96	201,538.1090	8.94%	8,235.74	5.49%	3.45%
1996-97	216,943.7576	7.64%	8,817.55	7.06%	0.58%
1997-98	233,074.2334	7.44%	9,528.54	8.06%	-0.63%
1998-99	248,994.9152	6.83%	9,948.34	4.41%	2.43%
1999-00	266,567.5135	7.06%	10,946.04	10.03%	-2.97%
2000-01	286,321.4918	7.41%	10,043.45	-8.25%	15.66%
2001-02	312,483.7066	9.14%	10,020.19	-0.23%	9.37%
2002-03	335,326.4787	7.31%	10,199.01	1.78%	5.53%
2003-04	360,710.2113	7.57%	10,670.40	4.62%	2.95%
2004-05	391,187.8147	8.45%	11,195.80	4.92%	3.53%

Not only has the growth in local property valuation been more robust than state tax collections, it has been steadier, less volatile. Measuring the volatility of the property valuation data during the period studied, we find that it measures .00924 standard deviations. This is considerably more stable than state tax collections which were shown to be 0.03294.

On the right column of Table 6 is a year-by-year comparison between the percent growth of property valuation with state tax collections. In ten of the fourteen years covered in the table, the rate of growth in property valuation

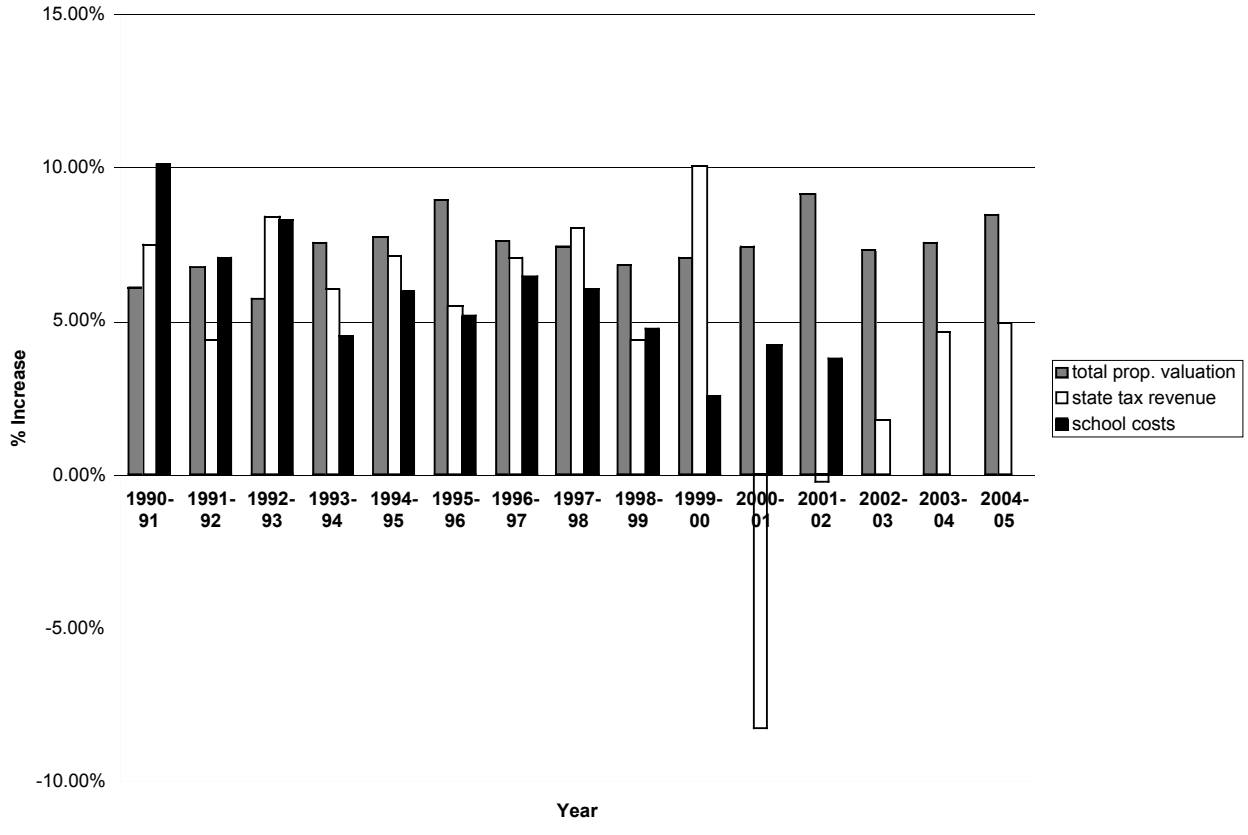
exceeded the rate of growth of state tax collections. This is true even in the latter part of the 1990s when state tax collections were particularly robust. Notably, when the economy softened and state tax collections declined, property valuation continued to demonstrate steady growth.

This simple comparison ignores a rich discussion of the economic analysis of the various factors that underlie the various state and local revenue producers. For example, the period covered in Table 6 was marked by low interest rates, which certainly contributed to the strength of property values. However, even understanding this shortcoming in the analysis, it is useful to understand two simple and significant facts. First, recent history shows that the growth of property valuation has exceeded the growth of state tax collections. Second, property valuation has been shown to be far more stable than state tax collections. This makes it somewhat curious why the Task Force would recommend moving a significant portion of school finance from one supported by property-based revenues to one that would be subject to the volatility of state taxes.

K-12 Spending Compared with State and Local Revenue Growth

Table 3 in this report showed the annual growth in school spending between 1990 and 2003. Figure 1 graphically shows how the growth in school spending compares to the annual growth in both state tax collections and in statewide growth in property valuation.

Figure 1 Property Valuation, State Tax Revenue, and School Costs, Yearly Percentage Growth, 1990-2005 (school costs not included for 2003, 2004, and 2005)



The picture that emerges from Figure 1 is that in many years, the growth in state tax collections lagged behind the growth of school spending. Yet in most years, including every year since revenue caps were enacted, the growth of property valuations exceeded the increase in school spending. After the imposition of revenue caps, the growth of property valuation towered over the growth in school spending.

Of course the picture that emerges from Figure 1 ignores many of the aspects of school finance that preoccupies much of the policy discussion. It does not examine the variations that exist between the hundreds of local school districts both in their spending habits and the growth in property valuation. It ignores the impact of other revenues, e.g. federal, on school spending. And, it does not factor in enrollment changes. However, recognizing these limitations, the statewide picture painted by Figure 1 suggests that on a statewide level, the property tax base had a proven capacity to keep pace with school spending increases. The same cannot be said for state tax collections.

The mismatch between school spending increases and flat or declining state revenues led state policymakers to retract its commitment to cover 2/3 of school costs. The drop in the state share of local school costs has been responsible for increasing the burden on local school boards and local property taxes leading to the "tension" which drove many of the Task Force recommendations. It was the volatility of state tax collections that directly led Governor Doyle to appoint the Task Force.

It is not possible to predict future revenue growth, particularly several years into the future.[18] However, some valuable lessons from the past should be kept in mind. First, with school finance so dependent on state funding, years in which state revenue growth falls below the growth in school spending will cause stress on the state budget. Further, when revenue growth stagnates over multiple years, as was the case in the 2000-2003 period, the stress on the budget can become untenable. Something has to give and that something has been an inability to maintain the commitment to school finance.

Based on the information in Figure 1 it appears likely that a revenue stream based on income and sales will experience more volatility over time than one based on the increase in the value of property. Moreover, it seems prudent to support schools through a more diverse, not less diverse, stream of revenue. In short, it seems imprudent to transfer a significant share of school cost from a property based tax system to the state tax system.

Impact of Low Revenue Growth on Property Taxes and Other State Budget Spending

The volatility of the revenue stream is never much of an issue during times when revenue growth is robust. For example, in the late 1990s on the eve of a recession, few policymakers or analysts were expressing concern with the variability of the revenue stream. But what happens when revenue growth stagnates? More specifically, what is likely to happen if the spending increases in local schools exceed the rate of increase in state revenue collections? This is an important question since analyses of the impact of major policy shifts often assume that the flow of dollars will be adequate to meet all policy goals. The recommendations from the Task Force on Educational Excellence implied that future state revenues would be adequate to support enhanced state funding. The Task Force report highlighted only the 20% reduction in property tax levies in the first year of implementation. Can a commitment to a lowered level of property taxes be sustained?

Earlier in this report it was shown that soft revenue collections in the 2000 to 2003 period rendered state government unable to maintain its commitment to fund 2/3 of school costs. The stress of that 2/3 funding commitment eventually became overwhelming in 2003 when the Governor and the Legislature removed the commitment from state statutes. This had a direct impact on local school budgets including Milwaukee Public Schools.

In considering the advisability of any major policy shift it is important to look at what the future holds. Specifically, what will happen in good economic times and what will happen when state revenue growth slows? This type of forward-looking analysis is often lacking.

To evaluate the advisability of using sales tax dollars to increase school aids we have created a model to test the change under different conditions. The model, shown in Table 7, allows a calculation of what will happen if state tax collections are healthy, here defined as 5% annual growth. Similarly, the model calculates what will occur if tax revenue growth slows, defined as 2% annual growth. (It should be noted that this level of growth is actually above the growth experience in the early years of the current decade.) The model assumes that school spending increases at 4.5% annually, slightly below the 4.8% average increase since revenue caps were made permanent in 1997.

The model is intended to examine the impact revenue growth has on key policy objectives. We have simplified the complexities of the state budget by categorizing all expenditures into one of two categories: school aids and all other expenditures. The model accentuates the trade-offs that will face the Governor and the Legislature. The trade-offs are between school aids and: funding for other local governments, funding for the University and Technical College systems, medical assistance funding, income tax cuts as well as support for all of the other programs in the state budget.

TABLE 7 INTERPLAY BETWEEN STATE REVENUE COLLECTIONS, NON-SCHOOL AID SPENDING, AND SCHOOL PROPERTY TAX GROWTH

	Strong State Revenue Growth (1)		Weak State Revenue Growth (2)	
	Non-School Aid Spending Grows at Same Rate as Revenue Collections	**School Aids Grow at Same Rate as School Spending**	**Non-School Aid Spending Grows at Same Rate as Revenue Collections**	**School Aids Grow at Same Rate as School Spending**
Non-School Aid Spending Growth				
2007	5.00%	5.50%	2.00%	1.40%
2008	5.00%	5.50%	2.00%	0.00%
2009	5.00%	5.50%	2.00%	-3.00%
School Property Tax Levy Growth				
2007	2.80%	4.50%	12.80%	4.50%
2008	2.80%	4.50%	12.00%	4.50%
2009	2.80%	4.50%	11.30%	4.50%

(1) Annual state revenue growth at 5%, annual school spending growth at 4.5%
(2) Annual state revenue growth at 2%, annual school spending growth at 4.5%

The model shown in Table 7 is based on the first three years after the initial year of implementation of the swap of sales tax revenues for property taxes. For illustration we have assumed the swap would occur in 2006. As schools become significantly more dependent on state aid, can state government maintain that commitment? Further, if it does, what will be the impact on the non-school aid portion of the state budget?

(Two caveats should be mentioned. First, the model ignores any residual budget shortfall that might be facing the state budget. A structural deficit is anticipated in the next biennial budget but that is not factored into the model. If it had been factored in the results would be worse. Second, the model attempts to portray the average effect on local property tax levies. The levy increase for any school district can vary considerably from the average.)

The left side of Table 7 shows what can occur if state revenue collections are strong (5% annual growth). Under this scenario state policymakers will have the ability to fulfill a commitment to school aids as well as meeting the needs of the balance of the budget. The top half of Table 7 shows the impact if priority is given to matching the growth of non-school aid programs with the growth in state revenues. These programs will receive 5% annual increases. The bottom of the table shows that, under this scenario the local school levy would be held to just 2.8% since the state would be able to increase school aids even above the 77% level. Needless to say when substantial dollars flow into the state coffers the strain on the state budget is greatly reduced.

But what is the impact if revenue growth is weak? That is shown on the right side of Table 7. Revenue growth is assumed to be 2% annually which is well above the actual collections in the 2001-03 period. Here we see that the policy makers will face difficult tradeoffs. The table shows that if the state increases the funding of non-school aid programs by 2% annually (the same as the revenue growth), there will be inadequate funding to maintain the commitment to school aids. As a result school aids will fall short of 77% of cost and local property taxes are likely to increase by more than 11% annually. Alternatively, if the commitment to school aids is maintained, the ability to fund other programs is curtailed to the point where a reduction of 3% would be needed by the third year.

State budgets often institute major policy initiatives with little attention given to sustainability. Before any new spending commitments are made the Governor and the Legislature must look to the future to evaluate what will occur when revenue growth slows, as it inevitably will. The approach in Wisconsin and many other states has been to cross that bridge when we get to it. The model helps show how shaky that bridge is likely to be. Frankly, the recommendation to lower property taxes with the use of sales taxes is simply not sustainable.

SUMMARY

Governor Doyle's Task Force on Educational Excellence has articulated an idea that has been circulating among policy analysts for years: ensure a large reduction in property taxes by increasing the sales tax. The Task Force sees such a move as lessening the tension between schools and the property taxpayers. The prospect of lower property taxes is enticing. However, as detailed in this report, any property tax relief should be viewed as temporary at best and will likely leave Wisconsin with both a higher sales tax and, in future years, large property tax increases.

One need only look back eighteen months ago to see how the weight of a commitment to fund 2/3 of school costs became untenable due to the slow growth of state revenues. The Governor and the Legislature are being asked to ignore that recent history and move to actually increase the state funding of schools. Such a move would have deleterious effects:

- State taxpayers would be saddled with a 20% increase in the sales tax.
- Property tax relief would be temporary at best.
- The ability of the Governor and the Legislature to accommodate other policy objectives, either to cut income taxes or to increase spending for other programs, would be severely restricted.
- When state revenue growth falls, property taxes are likely to rise by double-digits.

NOTES

1. The historical information on school aid is taken from a comprehensive review prepared by Jack Stark, *Property Tax and Tax Relief in Wisconsin* published in the 1991-92 Blue Book.

2. Ibid.

3. Based on data in the *Final Report of the Task Force on Educational Excellence*, June 30, 2004.

4. Legislative Fiscal Bureau calculation of partial school revenues (used to calculate the state share of school cost). June 18, 2004.

5. U.S. Census Bureau, Public Elementary-Secondary Education Finance Data, 2002, available at: <http://www.census.gov/govs/www/school.html> This is the most recent interstate comparison for K-12 spending.

6. Todd Barry and Dale Knapp, *Why Wisconsin Has High Taxes*, Published by the Wisconsin Policy Research Institute July 2003.

7. U.S. Census Bureau, Public Elementary-Secondary Education Finance Data, 2002, available at: <http://www.census.gov/govs/www/school.html>

8. The per student spending numbers differ from those in Table 2 because Table 2 uses data compiled by the U.S. Census Bureau while the data in Table 3 is taken from the Department of Public Instruction.

9. Based on the number of students qualifying for free or reduced lunch. 68% of MPS 10th grade students qualify based on data from the Department of Public Instruction's WINNS System.

10. The DPI WINNS System shows MPS having a high school habitual truancy rate of 46.2 % and a high school dropout rate of 9.898% (2003 data).

11. For example, of MPS 10th graders, only 29% scored as proficient or above in math. This compares with 69% of statewide 10th graders who scored proficient or above. The full summary of test results can be found on the DPI WINNS System.

12. Milwaukee Public Schools Superintendent Andrekopoulos' *Budget Overview* to the MPS Board, April, 2004.

13. The percentage will vary depending when the change would be implemented. The calculation used here applies the $1.44 billion swap to the 2003-04 partial school revenue base (used to calculate school aids) of $8.1 billion.

14. National Association of Officers, *Budgeting Amid Fiscal Uncertainty*, 2004.

15. For a discussion of the tax cuts see *Reforming Wisconsin's Budget for the Twenty-First Century* published by the Wisconsin Policy Research Institute, April 2003.

16. Standard deviation is a measure of how spread out data points (here, rates of state growth) are. To conceptualize it, start with the average rate of growth. Add the standard deviation to the average and subtract the standard deviation from the average to get two numbers. Given the previous data, there is approximately a 68% probability that a year's growth will fall between these two numbers. (This explanation leaves out some assumptions.) Thus, a higher standard deviation increases the distance from the average over which it is 68% probable that any particular year's growth will occur.

It is equal to the square root of the arithmetic mean of the squares of the deviations from the arithmetic mean.

The mathematical formula is:

$$S = \sqrt{\frac{\sum (X - \bar{X})^2}{n}}$$

17. This section is based on statewide property assessment data from the Department of Revenue. Of course this discussion does not incorporate the vast variation in property valuation changes that occur in different local jurisdictions.

18. The topic of the challenge of revenue forecasting in Wisconsin is addressed by Scott Niederjohn, PhD. in *State Revenue Forecasting in Wisconsin*, Wisconsin Policy Research Institute, May 2004.

About the Institute

The **Wisconsin Policy Research Institute** is a not-for-profit institute established to study public-policy issues affecting the state of Wisconsin.

Under the new federalism, government policy increasingly is made at the state and local levels. These public-policy decisions affect the life of every citizen in the state. Our goal is to provide nonpartisan research on key issues affecting Wisconsinites, so that their elected representatives can make informed decisions to improve the quality of life and future of the state.

Our major priority is to increase the accountability of Wisconsin's government. State and local governments must be responsive to the citizenry, both in terms of the programs they devise and the tax money they spend. Accountability should apply in every area to which the state devotes the public's funds.

The Institute's agenda encompasses the following issues: education, welfare and social services, criminal justice, taxes and spending, and economic development.

We believe that the views of the citizens of Wisconsin should guide the decisions of government officials. To help accomplish this, we also conduct regular public-opinion polls that are designed to inform public officials about how the citizenry views major statewide issues. These polls are disseminated through the media and are made available to the general public and the legislative and executive branches of state government. It is essential that elected officials remember that all of the programs they create and all of the money they spend comes from the citizens of Wisconsin and is made available through their taxes. Public policy should reflect the real needs and concerns of all of the citizens of the state and not those of specific special-interest groups.