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A State Fiscal Checkup

Prognosis is Better But Challenges Remain

Wisconsin's fiscal health has improved since 2010 due to an improving economy, repair of the unemployment reserve fund, and avoidance of raids on segregated funds to pay for general fund spending. Despite the gains, Wisconsin's rank among the states is at or below average on various fiscal measures. In 2017, the combination of the state's ending general fund balance and its rainy day fund equaled 5% of spending, a percentage smaller than in 35 other states.

Regardless of which party is in power, it is a given that those who control the statehouse will assert that state finances are healthy, while those out of power will question the state's fiscal management and health.

Fortunately, the state produces financial documents annually that help shed light on the nature of the state's fiscal condition. The little-known Comprehensive Annual Financial Report (CAFR) is a 250-page document containing vast information on revenues, expenditures, assets, and liabilities. It is analogous to the financial statements found in annual reports issued by publicly-owned companies. The state's latest CAFR—for the fiscal year ending June 30, 2017—was released in mid-February.

Though unfamiliar to most Wisconsinites, the CAFR is filled with data that are useful in evaluating state financial health. The document has advantages over other state reports and budget documents by covering all state revenues and spending, allowing a complete view of state finances.

For example, most press and political attention focuses on the state "general fund," even though it comprises only about half of state revenues and spending. This narrow focus can mask shifting of dollars from separate funds to erase would-be general fund deficits.

During 2003-11, lawmakers and the governor used $1.4 billion from the transportation fund to pay for general fund programs. While these transfers made the general fund appear healthier than it was, they also weakened the transportation fund.

State budget accounting also allows for spending in one fiscal year, while withholding actual payment until the next. This is most often done with state property tax credits. While they appear on December tax bills, the state does not fully reimburse local governments until the following fall. Like fund transfers, this maneuver makes the state general fund look superficially healthy.

Also in this issue:

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Because the CAFR is comprehensive, it ensures that transfers between funds do not mask financial condition. Moreover, the financial statements included in the CAFR are governed by Government Accounting Standards Board (GASB) rules. This means that accounting gimmicks, such as budgeting spending in one year and paying for it in the next, are corrected. It also means that figures reported are consistent across states and over time.

As this study went to press, the legislature was considering several bills that would affect state future fiscal health. Those actions are beyond the scope of this report.

MEASURING FISCAL HEALTH

When considering the health of state finances, time frame is important. A state could appear healthy in the short term, but unsound in the long term. It may be able to pay its bills now, but have long-term debt or unfunded retirement obligations that are unaffordable.

In this report, we assess the state's ability to meet its financial obligations over the short term (less than 60 days), the fiscal year, and the long term. Because no single metric perfectly measures fiscal condition, several are considered for each time frame.

This analysis measures the state's fiscal condition by examining how it has changed over time (2002-17), and how it measures up to other states.

SHORT-TERM HEALTH

Like households and businesses, states need resources available to pay bills as they come due. Consequently, it is instructive to consider three short-term measures that reflect the state's ability to meet its obligations over the first 60 days of the fiscal year (CAFR data are as of fiscal year end).

State governments have several types of assets in bank accounts or liquid investments that can be used to pay bills coming due within 60 days. These include money market accounts and are often referred to as cash equivalents. Investments in U.S. Treasury bills (short-term debt) also are very liquid, as are certain other investments. Additionally, the state may have receipts due within 30 days ("receivables"), such as federal aids, and it may hold other short-term assets that can be liquidated if needed.

Three measures of short-term fiscal health compare these liquid assets to what is owed over the next 60 days (short-term obligations). The sole difference in the measures is the liquidity of the assets.

Terms to Know

Assets. Items with economic value, including cash, investments, buildings, vehicles, roads, and amounts due from others.

Cash Equivalents. Very liquid investments that can be readily converted to cash or within three months of maturity.

Liabilities. Amounts owed to others. Short-term liabilities include amounts that must be paid within 60 days. Long-term liabilities include, among others, long-term bonds and post-retirement benefits.

Net Assets. The value of assets after subtracting outstanding debt used to acquire them.

Receivables. Amounts due from others.

The "*cash ratio*" compares very liquid short-term assets (cash, cash equivalents, and investments) to short-term obligations. A ratio above 1.0 indicates sufficient amounts of these assets to cover short-term liabilities.

The "*quick ratio*" adds receivables, which are slightly less liquid, to the assets included in the cash ratio. Finally, the "*current ratio*" adds to the quick ratio less liquid short-term assets, such as inventories (desks, chairs, computers, etc.).

All three measures, two of which are shown in Figure 1, show similar patterns over the past 15 years—

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erosion during 2002-09, then gradual improvement. However, despite post-recession gains, Wisconsin continues to lag most states on short-term fiscal position.

A 15-Year Roller Coaster

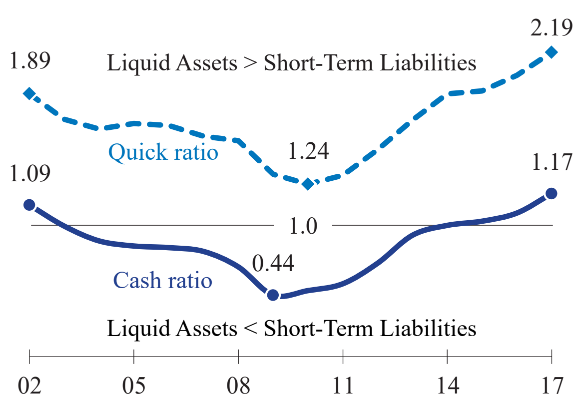
Long-time budget watchers are keenly aware of the state's fiscal difficulties during 2002-12, when the state's general fund often was balanced by shifting dollars from segregated funds. Less well known was the condition of the ailing unemployment insurance fund, which was bleeding dollars even during economic expansion. These factors caused erosion in short-term fiscal health. Recent economic expansion combined with fewer budget "gimmicks" have reversed the decline.

2002-09 Decline. Driven largely by deterioration in the state's unemployment fund, Wisconsin's most liquid assets were reduced by almost half during 2002-09, from $6.4 billion to $3.3 billion. The state's unemployment fund had $1.5 billion in cash and equivalents in 2002, but none in 2009. While a significant drawdown of the fund was to be expected during the 2007-09 recession, the health of the fund was deteriorating prior to that. In fact, by 2007, the fund's balance already had been cut in half, from $1.5 billion to $700 million.

Another 20% of the decline in liquid assets resulted from spending money generated from the 2001 securitization of a settlement with tobacco companies. State officials used that $1.3 billion to balance the 2001-03 state budget.

At the same time that liquid assets were declining, short-term liabilities were growing, from $5.9 billion in 2002 to $7.5 billion in 2009. Wisconsin's cash ratio fell from 1.09 in 2002 to 0.44 in 2009 (see Figure 1). In other words, as of June 30, 2009, the state had less than half the cash, equivalents, and investments it needed to pay its liabilities through the end of August that year.

Figure 1: Short-Term Health Improving
Cash and Quick Ratios, 2002-17



A second measure of short-term health, the quick ratio (which adds receivables to cash, equivalents, and investments), followed the same pattern during 2002-09. It dropped from 1.89 in 2002 to 1.31 in 2009 (dashed line in Figure 1) and reached its lowest level the following year at 1.24.

In 2017, three measures of short-term fiscal health were at their highest levels since at least 2002. Progress since 2009 was largely linked to increases at the U.W. System and in the state unemployment insurance fund.

Post-Recession Reversal. Wisconsin's short-term health reversed course beginning in 2010, due almost entirely to rising short-term assets. By 2012, cash, equivalents, and investments had increased by more than $2 billion, with about $900 million of the gain in the U.W. System. As the economy strengthened after 2012, short-term assets and state fiscal health continued to improve. By 2017, cash, equivalents, and investments totalled $8.0 billion, more than double the $3.3 billion the state had on hand in 2009.

About 29% ($1.33 billion) of the 2009-17 increase was due to a return to a solvent unemployment reserve fund. In 2008, the state gradually increased the amount of wages subject to the unemployment tax, from $10,500 in 2008 to $14,000 in 2013 and thereafter. That action, along with benefit changes and declining unemployment, helped reverse annual deficits in the fund. As of 2017, the fund had assets totalling more than $1.5 billion.

Another 29% ($1.34 billion) of the gain was from rising balances in the U.W. System; 17% ($798 million) was the result of higher ending balances in the state general and "rainy-day" funds.

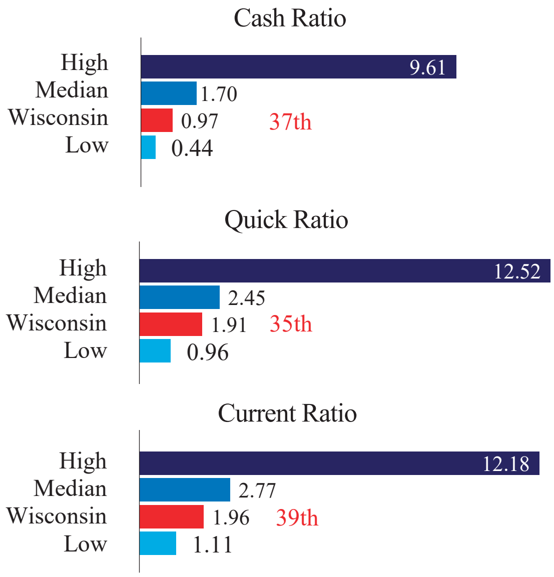
With rising short-term assets, Wisconsin's cash ratio climbed from 0.44 in 2009 to 1.17 in 2017, the highest since at least 2002. Growing cash and investments also pushed up the quick ratio, from 1.24 in 2010 to 2.19 in 2017.

National Comparisons

Post-recession gains in short-term fiscal measures are a positive sign for state finances. Despite those gains, however, Wisconsin ranks in the bottom half of states on short-term health in the most recent year for which data are available.

Over the past several years, researchers at the Mercatus Center at George Mason University have compiled these same measures for all states. Their 2017 study used information from fiscal 2015. The George Mason report showed Wisconsin's cash ratio of 0.97 ranked 37th among the states (see Figure 2). At 1.70, the 50-state median (half lower, half higher) was 75% higher than Wisconsin's 2015 ratio.

Figure 2: Short-Term Health Lags Nationally
Short-Term Ratios, Wisc. vs. High, Median, Low States, 2015



On the other two measures of short-term health, the Badger State held similar ranks—35th on the quick ratio and 39th on the current ratio.

George Mason researchers also combined the three short-term measures to create a single indicator of short-term health, on which Wisconsin ranked 38th. Among neighboring states, Minnesota (24th), Iowa (28th), and Michigan (36th) all placed ahead of Wisconsin, while Illinois ranked 48th.

FISCAL YEAR HEALTH

While a state's ability to meet its short-term obligations provides important perspective on state finances, a state's ability to balance its budget over the fiscal year and absorb unexpected shocks (such as recession) also is critical.

One fiscal year measure is the "*operating ratio,*" which compares total revenues to total expenditures. As with the short-term measures, a ratio greater than 1.0 is desired; that is, revenues are sufficient to fund annual expenditures. Recall that the CAFR accounts for revenues and expenditures from all funds, not just the relatively narrow general fund that is most often discussed.

A second measure looks at changes in net assets over the year. Net assets are the value of all assets, such as cash, investments, receivables, and buildings, minus any outstanding debt used to acquire them. Net assets rise when revenues exceed spending in a year and when the state pays off some of its outstanding debt.

Conversely, net assets decline when the state draws down balances or sells assets to fund expenditures.

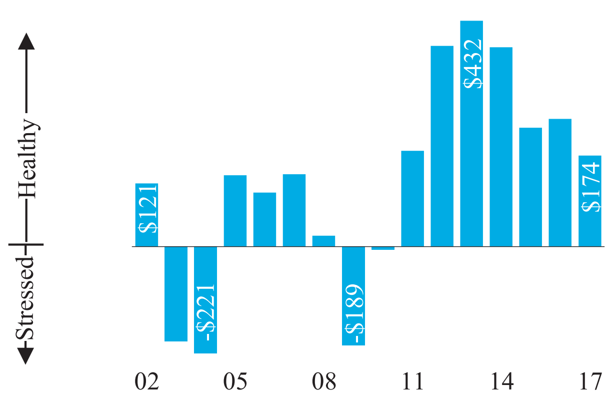
Fiscal Year Health Improving

Just as short-term health deteriorated during 2002-09, fiscal year health was weak through 2010. During that period, state expenditures exceeded revenues in five of nine years, resulting in operating ratios of less than 1.0. In four of those years, net assets declined (see Figure 3).

Among many factors contributing to the state's weak financial position, one that stands out was a continuing imbalance between revenues and spending in Wisconsin's unemployment reserve fund. In each year during 2002-10, including years of economic expansion, the state paid out more in benefits than it collected in unemployment taxes. In the five years in which total state expenditures exceeded revenues, unemployment deficits accounted for two-thirds of the gap.

During these years, lawmakers also used balances in segregated accounts, such as the tobacco settlement and injured patients compensation funds, to pay for general fund expenditures. Spending down these balances contributed to the revenue/spending imbalances and to the declines in net assets.

Figure 3: Fiscal-Year Health Improving
Change in Per Capita Net Assets, 2002-17



State budgets also diverted transportation taxes and fees to pay for general fund spending, and then authorized additional borrowing to pay for roads and highways. This additional borrowing negatively affected net assets.

The impact on state finances of a fiscally unsound unemployment insurance fund and use of unsustainable fiscal practices to balance the state general fund is evident in net asset totals. During 2002-10, total net assets declined $851 million, or more than $1 billion in inflation-adjusted terms.

Improvement After 2010. As mentioned, the state took steps in 2008 to fix the unemployment reserve fund, though those actions did not become effective until 2009. In addition, for the most part, lawmakers have ceased drawing down balances in segregated funds to pay for general fund spending.

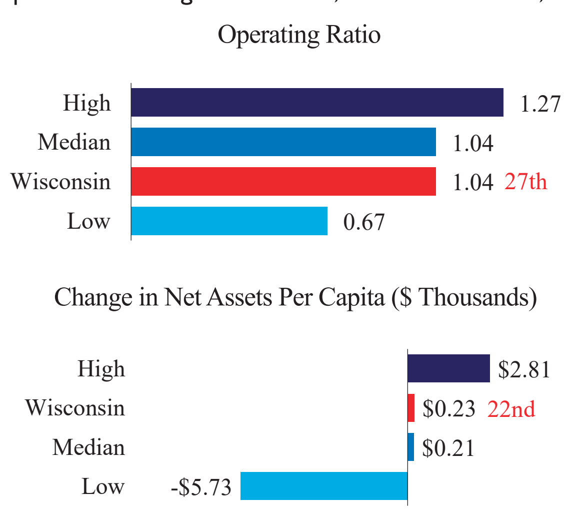
Since 2010, total state revenues exceeded spending in every year. In 2017, revenues of $36.5 billion funded spending of $35.2 billion. Thus, Wisconsin's operating ratio was 1.04. The state's operating ratio has now been above 1.0 for each of the past seven years.

Net assets have grown in each year during 2010-17. Over the seven years, net assets have increased more than $11.3 billion.

National Comparisons

In 2015, Wisconsin performed better vis-a-vis other states on fiscal year measures than on short-term ones. The state's operating ratio was 1.04 and ranked 27th among the states (see Figure 4). Its net asset gain per capita of $227 ranked 22nd nationally.

Figure 4: Fiscal Year Health Near Median State
Oper. Ratio and Chg. in Net Assets, Wisc. vs. Elsewhere, 2015



When the measures are combined, the Badger State ranked 27th, ahead of all neighboring states except Minnesota (15th).

LONG-TERM HEALTH

With so much attention focused on the budget every two years, policymakers often spend less time considering the long-term condition of state finances. Such consideration should include analysis of state borrowing to construct roads and buildings, as well as less-visible long-term obligations, such as paid employee absences (e.g., accumulated sick leave).

Since 2010, total state revenues exceeded spending in every year, a shift from the 2002-09 period. In 2017, revenues of $36.5 billion funded spending of $35.2 billion.

The size of these obligations is measured by two ratios. The first simply sums long-term liabilities and converts them to per capita amounts (*long-term liabilities per capita*) so they can be compared across states. The second compares them to total state assets (*liabilities relative to assets*). In both cases, lower figures are better.

A third measure looks at long-term health from a different perspective. The "*net asset ratio*" compares net assets to total assets. A higher ratio indicates greater long-term fiscal health.

State Debt Stabilizing

In 2017, Wisconsin had $15.8 billion in long-term liabilities. Almost 86% of those ($13.6 billion) were various forms of long-term debt. After rising significantly during 2004-13, total state debt has leveled off over the past four years.

From 2004 to 2013, Wisconsin's long-term debt increased 36.3%, or an average of 3.5% per year, from $10.1 billion to $13.7 billion (see Figure 5 on page 6). A variety of factors played roles, but one clearly stands out.

The short-term and fiscal year impacts of using transportation taxes and fees to pay for general fund spending is evident in the fiscal year measures previously discussed. But there were also long-term consequences. Because state budgets authorized additional general obligation borrowing to replace lost transportation revenues, state debt increased.

General Fund Health

While CAFR figures can be used to evaluate overall state financial condition, it is also useful to examine the health of the narrower state general fund. The general fund supports school aids, municipal and county shared revenues, corrections, Medicaid, the U.W. System, among other programs. General fund revenues are primarily individual and corporate income taxes, sales taxes, and liquor and tobacco taxes.

The CAFR does provide detail on the budgetary general fund. Thus, we focus here on general fund savings available to cushion the general fund budget when revenues lag or a recession occurs. Budget analysts generally recommend these savings be at least 5% of spending.

Because revenue forecasts are uncertain, Wisconsin generally budgets to spend less than what is expected to be available in revenues. Ending general fund balances provide a buffer should revenues lag projections or unexpected costs arise in a given year. The rainy day fund is used when revenues are impacted by "below normal economic activity," such as recession.

During 2002-11, Wisconsin had little savings to protect itself from unforeseen events. As the chart below shows, the combination of ending balances and the rainy day fund were typically less than 1% of spending. In fact, the only state less prepared for the 2007-09 recession was Arkansas.

That has shifted somewhat over the past six years. While the rainy day fund was largely empty for most years prior to 2012, it now has a balance of $283 million. Combined with an ending general fund balance of $579 million, Wisconsin ended 2017 with a cushion of 5.0% of general fund spending. While substantial relative to pre-2012 figures, Wisconsin remains less-prepared for a downturn than most states. Thirty-five states had larger savings in 2017 than Wisconsin.

General Fund "Savings" Improving
Ending Balances & Rainy Day Fund, % of Expenditures

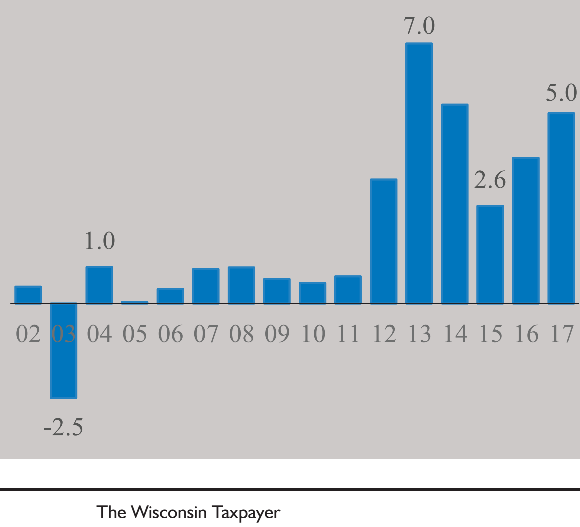
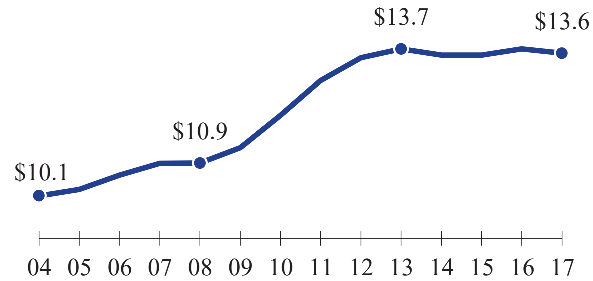


Figure 5: Long-Term Debt Stabilizing
Total State Government Debt, $ Billions, 2004-15



Of the $3.7 billion increase in debt during these years, more than $1 billion can be attributed to those actions.

Also during those years, revenue bonds to fund transportation projects increased $600 million, and total debt for projects within the U.W. System increased by more than $1 billion.

Since 2013, total state debt has stabilized. While general obligation and transportation revenue bond debt has increased by more than $600 million, these have been offset by declines in other areas, particularly environmental improvement bonds.

Long-term Health Improving

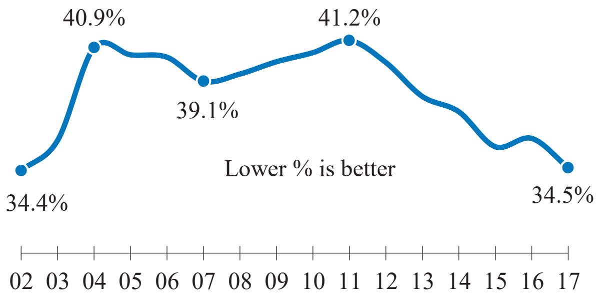
With $15.8 billion in long-term liabilities and a population of 5.8 million, the state owed $2,739 per capita in 2017. That amount was down slightly from 2016 ($2,802), but was higher than all other years studied. Adjusted for inflation, this measure was less in 2017 than in every year during 2011-16, except 2015.

When we compare liabilities to total state assets, we see that long-term health weakened during 2002-11, largely because of rising state debt. In 2002, liabilities were 34.4% of state assets; by 2011, they were 41.2% (see Figure 6, page 7).

After 2011, growth in state debt slowed and then levelled off. With total assets continuing to rise, Wisconsin's long-term liability ratio dropped to 37.5% in 2014 and to 34.5% in 2017.

The third measure of long-term health shows a similar pattern. The net asset ratio, which compares net assets to total assets, declined from 1.8% to -18.0% during 2002-10. Since then, it has recouped all of the decline and stands at 1.8% again in 2017. This measure confirms state long-term health has returned to 2002 levels.

Figure 6: Long-Term Health Improving
L.T. Liabilities % of Assets, 2002-17

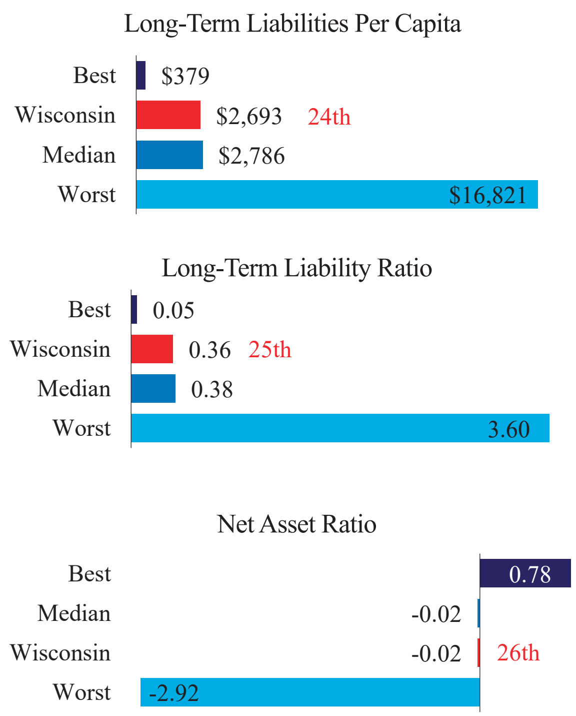


National Comparisons

As is evident with regard both to short-term and fiscal year health, Wisconsin's long-term health is improving. However, on all three long-term measures, Wisconsin is about average when compared to other states. National figures from 2015 show Wisconsin ranked 24th among the states on long-term liabilities per capita; 25th on the long-term liability ratio; and 26th on net asset ratio (see Figure 7).

When individual measures are combined, Wisconsin ranked 27th nationally on long-term health in 2015. Iowa (10th), Minnesota (22nd), and Michigan (24th) all ranked higher, while Illinois placed 49th. In 2014, Wisconsin ranked 38th.

Figure 7: Wisconsin Average on Long-Term Health
Three Measures of L.T. Fiscal Health, Wis. vs. Elsewhere, 2015



SUMMARY

The measures reported here provide a fairly consistent picture of Wisconsin's fiscal health. During 2002-10, lawmakers failed to address structural issues in the unemployment reserve and general funds. Using reserves in other funds to balance state budgets left the state vulnerable when the 2007 recession hit. During these years, measures of short-term, fiscal year, and long-term health deteriorated.

Several factors contributed to an improvement in subsequent years. Economic expansion played a critical role, as it produced growing tax revenues and declining expenditures in many state assistance programs, particularly unemployment insurance. A return to a solvent unemployment reserve fund was aided by changes approved in 2008. Finally, state leaders have largely ended the practice of using segregated funds to pay for general fund spending and have been conscious of state debt levels.

The result was that, for all three perspectives of financial condition, 2017 fiscal health returned to, and in some cases exceeded, 2002 levels.

This good news is tempered by comparison to other states, which shows that Wisconsin is at best average, and on short-term measures, well below most states.

Significant improvements in state fiscal health are rarely accomplished in a single year, as evidenced by Wisconsin's gradual gains since 2010. Rather, achieving a strong fiscal position requires annual fiscal discipline, constant vigilance, and long-term decision making.

Obstacles to continued improvement in Wisconsin include state transportation needs, which appear to outstrip transportation fund revenues. Questions about future state spending on health care in light of the turmoil surrounding the Affordable Care Act also need to be resolved. And, while the state and national economies are strong now, recession can arise with little notice.

Because of such unpredictability, state leaders would be wise to budget sufficient ending balances in the general fund and make consistent rainy day fund deposits. Moreover, given the state's past experience with its unemployment fund, maintaining a healthy fund balance in that area also would be prudent. □

DATA SOURCES

Mercatus Center of George Mason University; Wisconsin Department of Administration, CAFR; Wisconsin Legislative Fiscal Bureau.

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WISTAX NOTES

■ **Is Migration Stabilizing?** After a steady worsening during 2000-10, the net outmigration of Wisconsin residents appears to be stabilizing. Between 2015 and 2016, 90,978 people moved out of Wisconsin, either to another state or out of the country, while 83,763 residents of other states or nations moved here. The state's net loss of 7,215 residents from migration is a slight improvement over the prior two years (see chart), according to Internal Revenue Service figures based on income tax filing.

Net migration here has been on a long downward trend. In 1993, the number of people coming to Wisconsin outstripped those leaving by 16,420. Seventeen years later, there were 10,091 more residents leaving the state than entering.

Part of shift has been due to baby boomers retiring to other states, particularly Florida and Arizona. During 2013-16, about 25% of Wisconsin's net loss of residents was due to tax filers 55 or older.

However, Wisconsin is also losing young adults. Filers 26 or younger comprised about 8% of all Wisconsin filers during 2013-16. However, they accounted for almost 30% of the state's net loss of residents. Many are likely recent high school graduates going out of state for college. With unemployment rates near record lows throughout the state, the question for policymakers is: Will these young adults return to the state upon graduation?

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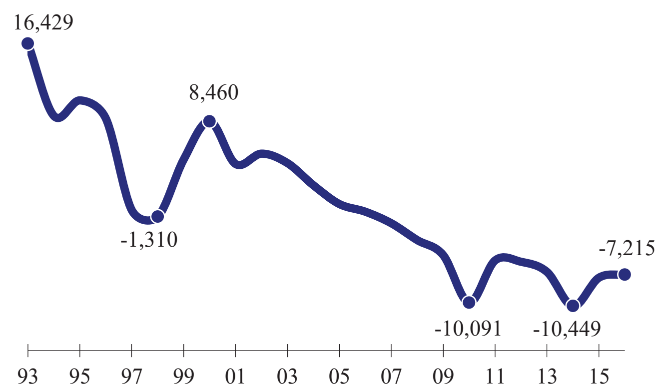
Wisconsin Net Migration Stabilizing
Net Migration (In Minus Out), 1993-2016



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- Welcome to the Wisconsin Policy Forum (#1-18)
- School finance: Here vs. elsewhere (#2-18)
- Spring elections in Wisconsin (#3-18)

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