

# Stateline Midwest

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## Another balancing act

### State-by-state snapshot of budget proposals shows varying paths that lawmakers may take to erase deficits

by *Laura Kliewer (lkliewer@csg.org)*

In the Midwest, every state except North Dakota has had to erase a budget deficit during the current fiscal year and is also having to close gaps for the year ahead.

The shortfalls for FY 2012, too, are quite large in many states. According to the Center for Budget and Policy Priorities, the gaps are equal to 10 percent or more of total FY 2011 budgets in five Midwestern states: Illinois, Minnesota, Ohio, South Dakota and Wisconsin.

The fiscal crisis is now entering its fourth year in most states, and collectively, policymakers in the region have already employed a broad array of budget-balancing strategies: spending cuts, tax increases and other revenue enhancers, a drawing down of reserves, inter-fund transfers, salary and hiring freezes, employee furloughs, deferred payments and delayed tax cuts.

They also have relied heavily on an infusion of federal stimulus funds — money that is largely gone as new budgets are being crafted. As a result, and because many short-term fixes have been exhausted, balancing FY 2012 budgets is shaping up to be the toughest challenge yet for legislators and governors in many states.

States, too, are already somewhat limited in what they can do, notes Scott Pattison, executive director of the National Association of State Budget Officers.

“You have to spend a certain amount on Medicaid, school formulas require a certain amount on K-12 education, the federal government has strings attached to a lot of things,” he says.

“There is no easy answer. And in some way it kind of frustrates people because they wish there was; on the other hand, it makes it easier to say, ‘You know what, there’s just no magic bullet here.’”

During the current fiscal crisis, most states in the Midwest have chosen not to enact broad-based tax increases — a trend likely to continue as new annual and biennial budgets are finalized. Most of the governors’ State of the State addresses, as well as many early proposals from state legislatures, have

#### State tax collections in 2009

State	Per capita	U.S. rank	% of personal income	U.S. rank
Illinois	\$2,267	27	5.4%	7
Indiana	\$2,320	26	6.8%	17
Iowa	\$2,322	25	6.2%	25
Kansas	\$2,375	23	6.2%	27
Michigan	\$2,363	24	6.7%	18
Minnesota	\$3,259	8	7.6%	9
Nebraska	\$2,227	30	5.7%	34
North Dakota	\$3,732	4	9.4%	4
Ohio	\$2,075	35	5.8%	33
South Dakota	\$1,642	47	4.3%	48
Wisconsin	\$2,563	17	6.8%	16
U.S. states	\$2,334	—	5.8%	—

Source: Federation of Tax Administrators (using U.S. Census Bureau data)

focused on the spending side. Here is a snapshot of some of the actions taken and proposals being considered in the region. (Ohio is not included in this article because the governor’s budget proposal had not yet been introduced as of late February.)

#### Illinois

The first budget-balancing action of the new year was an exception to the region’s no-new-taxes trend. Just hours before a

newly elected class of legislators was sworn into office, the Illinois General Assembly approved an increase in the state’s personal and corporate income taxes. The state’s flat income tax was raised from 3 percent to 5 percent, and the corporate rate was increased from 4.8 percent to 7 percent.

These higher rates are scheduled to stay in place until 2015.

Over this same time period, Illinois will also be operating under a new spending cap: Annual growth in the state budget will be limited to 2 percent. If the Illinois auditor general determines that an adopted budget in a given year exceeds the limits, the tax increases will be nullified.

Along with the spending caps and tax increase, the Illinois legislature tried to get a better handle on its fiscal conditions by enacting a series of cost-containment proposals in the state’s public health care programs, including Medicaid. Changes include moving more beneficiaries into managed-care plans, cutting down on fraud and abuse, and encouraging a greater use of home- and community-based care options.

Illinois has not been alone in raising taxes to help close budget deficits. Kansas adopted a temporary 1-cent increase in its sales tax in 2010, and at least two other Midwestern states have raised income taxes in recent years. Wisconsin imposed higher taxes on its highest earners, while Michigan

▶ PLEASE TURN TO PAGE 6



*Though tax revenues are beginning to rebound, this is the toughest budget year yet in many states as they continue to manage the most difficult fiscal period in at least a generation. This month’s cover story provides a state-by-state snapshot of some of the budget proposals in the Midwest.*

▶ CONTINUED FROM PAGE 1

## To address budget gaps, deep spending cuts expected; tax increases unlikely in most states

raised the state's flat income tax rate in 2007. (That increase begins to be phased out in FY 2012.)

### Indiana

In Indiana, Republican Gov. Mitch Daniels presented a FY 2012-2013 budget that freezes funding for many items, including K-12 education, at levels in the current biennium. The state's universities would experience an additional 3 percent cut on top of the 6 percent reduction they received in 2010 and 2011.

His proposed budget also eliminates Medicaid services that are optional under federal law — dental care and podiatry and chiropractic services — while increasing overall spending on Medicaid and public employee pensions.

Daniels says his plan would leave the state with \$725 million in budget reserves.

As of February, the Indiana House appeared headed toward approving a fiscal plan with many of the strategies laid out by the governor: freeze overall spending, protect K-12 education from cuts, avoid tax increases and leave the state with a structurally balanced budget at the end of the two years.

Republican Rep. Jeff Espich says the House plan, as passed out of the Ways and Means Committee that he chairs, cuts appropriations to most state agencies by 15 percent (compared to FY 2011 levels) and eliminates a part of the school-funding formula that provides extra dollars to schools with declining student enrollment. Overall spending on public schools would not be cut. In addition, various news outlets reported that some of the optional Medicaid services were maintained

in the House committee's plan.

### Iowa

A week before newly elected Republican Gov. Terry Branstad delivered his budget address, the Republican-led Iowa House had already passed HF 45, dubbed the Taxpayers First Act by legislative supporters. The measure seeks to save the state roughly \$475 million over the next three years through a variety of reductions and cuts: for example, eliminating state-funded preschool for all 4-year-olds, smoking cessation programs, family planning services, and funding for new passenger-rail service between Chicago and Iowa City. HF 45 would also do away with several commissions and agencies, charge state employees for health insurance (at least \$100 a month), and eliminate special funds that provide grants for renewable energy projects and businesses.

Branstad praised HF 45 as an "important first step toward budget sustainability." (The state has an estimated FY 2012 budget deficit of \$263 million.) His own budget proposal spares K-12 education from cuts, but it does call for a 6 percent reduction in funding for the state's universities. Most state agencies would incur cuts of between 5 and 8 percent.

As of February, the Democrat-controlled Senate was exploring the merits of the different cost-cutting proposals included in HF 45.

Iowa Democratic Sen. Jeff Danielson says that what is likely to remain in HF 45 are components consistent with what he calls "Reinvent Iowa 2.0" — a reinvention of state government that began in 2010.

"We saved almost a quarter billion dollars" as a

result of the changes adopted last year, he says. "We see many of the efforts in the House file as a continuation of that."

Those 2010 changes included consolidating information technology services within Iowa government, centralizing the purchasing of goods and services, establishing a new supervisor-to-employee ratio to eliminate middle-management positions in state government, and establishing a permanent efficiency-review committee within the legislature.

### Kansas

Last year, Kansas legislators used a combination of cuts and an increase in the sales tax to balance the state's FY 2011 budget.

The state now faces an estimated \$492 million shortfall for FY 2012, primarily because of the loss of federal stimulus funds that helped, among other things, prop up school funding.

In his proposed budget, the state's new governor has decided not to replace that loss of federal K-12 education dollars with additional state funds. If Republican Gov. Sam Brownback's proposal is approved, base state aid for schools would be cut by 5.8 percent and would be at its lowest level since 1999-2000.

Brownback has also recommended cutting, merging or eliminating funding to a number of state agencies and commissions. He began doing that in February, issuing an executive order to abolish the Kansas Arts Commission, which he said would save \$600,000 in FY 2012. He appointed a nonprofit arts foundation to raise funding for the arts.

As of February, too, the governor and Legislature were considering further cuts for FY 2011, including proposals to cut by 7.5 percent the wages of state elected officials and state employees earning more than \$100,000 a year.

### Michigan

In Michigan, the new fiscal year won't begin until October, but work on the FY 2012 budget began in earnest after newly elected Republican Gov. Rick Snyder unveiled his budget proposal in February.

The governor's proposal will provide a starting point for Michigan lawmakers as they look to restructure their business tax (a move that would decrease revenue to the state in FY 2012) while also balancing a projected deficit of \$1.4 billion.

Snyder's proposed cuts include 4 percent and 15 percent reductions in K-12 education and state university spending, respectively. On the social services side, he proposes a lifetime limit of welfare benefits on most residents and a new 1 percent health care insurance assessment on all paid health care and dental insurance claims.

Another piece of his plan restructures the state's revenue-sharing arrangement with local governments. He proposes an elimination of the portion of revenue-sharing payments that are subject to annual appropriations. (Some of the revenue that goes to local units is constitutionally dedicated.) Instead, cities, villages and townships would receive financial incentives for meeting specific standards, agreeing to share services and adopting other best practices in government reform.

Snyder does not focus exclusively on spending cuts. He has, for example, proposed to begin taxing pension income; to do away with most income-tax credits and deductions; and to eliminate several tax credit programs, including the state's earned-income

### Light at the end of the tunnel: Upturn in state revenues a positive sign

For states, there is good news even as legislatures and governors deal this year with the most difficult fiscal conditions in recent memory.

"The revenue crisis is ending," says Donald Boyd, senior fellow with the Rockefeller Institute of Government.

And though the fiscal crisis is continuing, recent data collected by Boyd (see table) are an encouraging sign that the worst might soon be behind states.

"Revenue has stopped falling off a cliff," Boyd says. "Every state at a minimum has bottomed out, and virtually all of them are beginning to climb upward."

During the first two quarters of fiscal year 2011 (the third and fourth quarters of the 2010 calendar year), revenue from personal income taxes in every Midwestern state was higher over the previous year (with the exception of South Dakota, which does not have a personal income tax). Sales tax revenue was also higher in almost every state (Illinois' sales tax revenue fell in the first quarter of FY 2011, but rebounded strongly in the second quarter).

Corporate income tax collections have not been as strong, but Boyd cautions that those numbers can be quite volatile and, as a result, are not necessarily a good reflection of overall economic and revenue trends.

Along with the increases in tax collections during the first part of fiscal year 2011, the employment picture in the Midwest is improving: between December 2009 and December 2010, jobless rates fell in nine of the region's 11 states (only Kansas' rate increased; South Dakota's rate was unchanged).

"The good thing is, this is not a huge crisis, it is doable, this can be dealt with," says Scott Pattison, executive director of the National Association of State Budget Officers. "A lot of the press lately has kind of misread the situation as more dire than it is. [We've heard] some ridiculous things like defaults on bonds, which is just not going to happen on the state level. It's difficult, but we have survived the worst."

% change in state tax revenue		
State	July-September 2010 vs. July-September 2009	October-December 2010 vs. October-December 2009*
Illinois	+2.4%	+12.4%
Indiana	+5.8%	+8.0%
Iowa	+9.1%	+9.2%
Kansas	+9.3%	+9.2%
Michigan	+1.4%	-1.8%
Minnesota	+13.2%	+6.7%
Nebraska	+4.9%	+2.9%
North Dakota	+29.8%	+35.5%
Ohio	+6.6%	+6.7%
South Dakota	+1.1%	+9.5%
Wisconsin	+11.4%	+2.0%
U.S. states	+4.5%	+7.6%

\* Figures are preliminary

Source: Rockefeller Institute of Government

tax credit program for the working poor and tax incentives for certain business sectors such as the film and battery-manufacturing industries.

## Minnesota

For most states in the Midwest, one party has full control of the legislature and governor's office, with the two exceptions being Iowa and Minnesota.

In Minnesota, budget disagreements between the GOP-led Legislature and Democratic Gov. Mark Dayton became apparent early on in the year.

Dayton's first veto as governor was a bill designed to cut state spending in next year's biennial budget by more than \$800 million. Many of the reductions would have come through a continuation of cuts in aid to local governments — a move that Dayton said would lead to higher property taxes. HF 130 also proposed reductions in higher education and the state's health and human services programs.

In February, the governor laid out his plan to erase the state's budget deficit, which is projected to be \$6.2 billion for the next biennium.

A centerpiece of Dayton's proposal is to add another tier to the state's graduated income tax structure, thus raising rates on joint filers earning more than \$150,000 and individuals earning more than \$130,000. He also wants to levy a temporary income surtax of 1 percent on tax filers with income of more than \$500,000 and to collect a statewide property tax on homes valued at more than \$1 million.

Dayton is calling for a 6 percent cut to the state's colleges and universities, a 6 percent reduction in the state workforce, and a cap on state-subsidized health insurance at 200 percent of the federal poverty level (the state's current cap is at 275 percent). His plan increases K-12 funding for education, primarily to fund all-day kindergarten statewide, and maintains the current level of local government aid.

## Nebraska

The question of aid to local governments has also become a part of budget talks in Nebraska — a state where the Unicameral Legislature used a unique process during the interim in 2010 to help shape fiscal decisions this year and to help close a projected biennial budget deficit of nearly \$1 billion.

That process was the result of LR 542, which created an ad hoc legislative committee to review all areas of state government and to recommend options for reducing and eliminating programs. As part of the review, each of the Legislature's 14 regular standing committees was charged with identifying potential cuts totaling 10 percent of general-fund appropriations for state agencies within their jurisdiction. (Cuts did not have to be 10 percent from each agency; rather, the total reduction for all agencies within the committee's jurisdiction was to be 10 percent.)

The list of options was released in December, and Republican Gov. Dave Heineman said many of the proposals were included in his budget proposal for the new biennium.

One of many components in the plan would end state aid to local cities, counties and natural resource districts. Other strategies include eliminating as many as 500 positions in state government, cutting provider rates for certain Medicaid providers (5 percent under the governor's proposal, 4 percent under an initial legislative proposal), and rescinding public health coverage for certain legal immigrants as well as people who don't meet welfare-to-work requirements.

In its initial proposal, the Legislature provides more money than the governor does for state aid to K-12 education, but in both plans, local schools lose revenue due to expiring federal stimulus funds.

### List of common strategies used by states to close or reduce budget gaps

Strategy	# of U.S. states reporting use of strategy in FY 2011	Midwestern states reporting use of strategy in FY 2010 and/or FY 2011
User fees	19	Illinois, Michigan, South Dakota and Wisconsin
Higher education-related fees	13	Illinois, Kansas and Wisconsin
Court-related fees	9	Illinois, Kansas and Wisconsin
Transportation/motor vehicle-related fees	10	Illinois, Kansas, South Dakota and Wisconsin
Business-related fees	11	Illinois, Michigan, South Dakota and Wisconsin
Layoffs	24	Illinois, Indiana, Iowa, Michigan, Nebraska and Wisconsin
Furloughs	16	Illinois, Iowa and Wisconsin
Early retirement	6	Iowa and Michigan
Salary reductions	9	—
Employee benefit cuts	13	Indiana and Michigan
Across-the-board cuts	25	Indiana, Iowa, Kansas, Michigan, Minnesota, Nebraska and Wisconsin
Targeted cuts	35	Illinois, Indiana, Kansas, Michigan, Minnesota, Nebraska, South Dakota and Wisconsin
Reduce local aid	19	Illinois, Kansas, Minnesota, Nebraska and Wisconsin
Reorganize agencies	14	Indiana, Iowa, Michigan and Wisconsin
Privatization	4	Indiana
Rainy day fund	13	Indiana, Iowa and Nebraska
Lottery expansion	5	Michigan
Gaming expansion	3	Illinois
Other	21	Michigan, Minnesota, Nebraska, Ohio and South Dakota

*Source: National Association of State Budget Officers ("Fiscal Survey of States," Fall 2010)*

## South Dakota

In South Dakota this year, a proposed 10 percent cut in education became the focal point of discussions inside the Capitol.

That proposal was part of Republican Gov. Dennis Daugaard's plan to erase the state's structural deficit of \$127 million (other areas of state government would be reduced by 10 percent as well).

He urged lawmakers to resist not only tax increases, but the use of reserve funds as well.

In a February opinion piece in the Capital Journal newspaper arguing for the school-funding reductions, Daugaard noted that over the past eight years, South Dakota has had a decline in student enrollment but is spending \$90 million more in aid to schools.

Many legislators, though, appeared hesitant to adopt a 10 percent reduction in certain areas of government. An alternate proposal released in January by Democratic leaders in the state called for using reserve funds to help maintain school and Medicaid funding at their current levels. Under their plan, too, the structural deficit would be erased over three years instead of one.

A third approach aims to curb the education cuts by changing a state law on state-local funding ratios. Under that law, regardless of the per-student dollar amount for K-12 education that the state appropriates each year, its share must be 56.5 percent, with local property taxes making up the rest. SB 152, passed by the Senate in late February, would temporarily suspend this law. As a result, property taxes would remain at the same level as in the current fiscal year, thus partly mitigating local schools' loss of state revenue.

## Wisconsin

Protests and legislative debate in Wisconsin dominated national news for weeks, and they began with the Feb. 11 release of Republican Gov. Scott Walker's budget-repair bill for the remainder of the fiscal year.

The governor's proposal went beyond filling a budget gap of \$137 million; he said his plan was intended to "lay the foundation for a long-term sustainable budget."

In particular, he has targeted several changes for public employees. For starters, Walker says, workers who are part of the Wisconsin Retirement System should contribute 50 percent of their annual pension payment — an amount that would equal about 5.8 percent of their salaries. (According to Walker, most workers have been contributing little or nothing.) Second, he says the time has come to increase employees' contributions to their annual health insurance premiums to at least 12.6 percent, compared to the current contribution level of approximately 6 percent.

The proposal that caused the most controversy limits collective bargaining for most public employees to wages only. Collective bargaining units would also be required to take annual votes to maintain certification as a union.

Other ideas advanced by Walker include refinancing the state's debt to push principal payments into the future, allowing for the sale of state heating plants and giving the state Department of Health Services broad authority to change the state's health programs to address rising Medicaid costs (this last measure includes a mechanism for the legislature to reject or modify the changes).

In all, the state is facing a budget shortfall of more than \$3 billion for the next biennium.

To plug a \$6 billion gap in the FY 2009-2011 budget, lawmakers employed a combination of spending reductions (including across-the-board agency cuts) and tax increases. Income taxes were increased for individuals earning more than \$225,000 and for couples earning more than \$300,000. In addition, taxes on tobacco products were raised, capital gains exclusions from the state income tax were decreased; and a tax credit for film productions was modified. ★