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FY 2010 Closeout Report

RESETTING INDIANA'S FUTURE

How the Recession and the State's New Fiscal Realities Will Drive the General Assembly's Budget-Making

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FY 2010 CLOSEOUT REPORT

Resetting Indiana's Future: How the Recession and the State's New Fiscal Realities Will Drive the General Assembly's Budget-Making

Executive Summary

Anyone who has driven the narrow roads down steep mountainsides out West has a sense of what this recession has meant to public officials responsible for developing budgets. It's been a white-knuckle ride through the worst recession since the Great Depression and there are few signs that the drive's about to level out.

The recession hasn't been a Sunday drive for Indiana's budget-minders as the recent year-end closeout showed. But an existing surplus, a set of aggressive spending cuts and a dose of federal stimulus dollars leave Indiana with a choice of roads to take as the economy continues to struggle.

This report by the Indiana Fiscal Policy Institute analyzes the state's fiscal condition. It shows how the recession has created a structural budget deficit and describes the options available to the governor and the General Assembly as they write a new two-year budget in the next legislative session.

Among the report's major findings:

--Indiana has not faced a revenue crisis like this since at least 1980, possibly ever. The state collected 1.1 percent less revenue in FY 2009 than it did the previous year. Tax collections plunged 5.8 percent the next fiscal year, rates of decline not seen before in Indiana.

--The revenue-killing recession and not irresponsible spending has created a structural deficit going into the fiscal 2012-13 budget. Indiana's revenue collections are at 2005 levels while spending has increased even with major spending cuts.

--The federal stimulus did not cause the structural deficit. Nor has it solved it. Indiana used the stimulus money as a bridge across the worst of the revenue losses. The stimulus was used much as existing state reserves--treated as one-time funding--to ensure the money did not become part of the state's base spending.

--The governor's spending cuts have mitigated the problem through the current fiscal year.

--Indiana's changing tax mix means it must rely more heavily on income and sale taxes for revenue at a time when both have become more volatile and therefore much more difficult to predict.

--Elimination of state property tax relief means there is more money for education, but less funding flexibility during the recession.

--Despite its relative strength of budget, Indiana's budget-writers face difficult choices in the coming session, including further cuts, tax increases or both.

There is no roadmap for a trip through this recession, so the governor and legislators will have to be careful or they'll take a turn for the worse.

A Steep Hill with No Brakes

Indiana faces its most challenging fiscal outlook in at least 30 years. The recession that began in November of 2007 is not over. Unemployment in the state remains above 10 percent, increasing from 10.1 percent to 10.2 percent in July 2010. The national economy is not adding jobs at a meaningful rate nearly three years after the onset of the recession.

While Gross Domestic Product is increased by 1.6 percent in the 2nd quarter this year, the rate of growth has slowed. This recession almost certainly will be 18 months or longer in duration, making it the longest downturn since the Great Depression and nearly twice the duration of the average recession since World War II.

Tax revenue is a function of economic activity and the recession has exacted the expected toll on tax revenue. In the last two years tax revenue has fallen at rates never before seen in Indiana. The revenue loss in fiscal years 2009 and 2010 represented 1.1 percent and 5.8 percent year-over-year declines in revenue collection.

ARRA Funding

to Support FY 2010-2011Biennial Budget [in millions]

	FY 2009	FY 2010	FY 2011
K-12 Tuition Support	$536.4	$209.1	$207.1
Higher Education	$44.3	$33.9	-0-
Medicaid	$397.8	$564.9	$525.9
General Purpose	$0.0	$147.0	$36.0
Total	$978.5	$954.9	$769.0
Grand Total ARRA funds in Support of Indiana General Fund Budget			$2,702.40

Table 1. Source: Indiana State Budget Agency. Medicaid Expenditures are estimated based on available information.

In response to the significant drop in revenue, the governor has cut spending significantly, reverting[1] $1.4 billion in FY 2009 and $785 million in FY 2010.[2]

While the governor was adjusting Indiana's expenditures to more accurately match revenue, the federal stimulus package, the American Recovery and Reinvestment Act (ARRA), supplied a significant amount of funding that helped keep appropriations from being reduced even further. As a result of several bills approved by Congress, the ARRA monies provided $2.7 billion of funding in Fiscal Years 2009, 2010, and 2011, including funding passed in August 2010 by the federal government (See Table 1). [3]

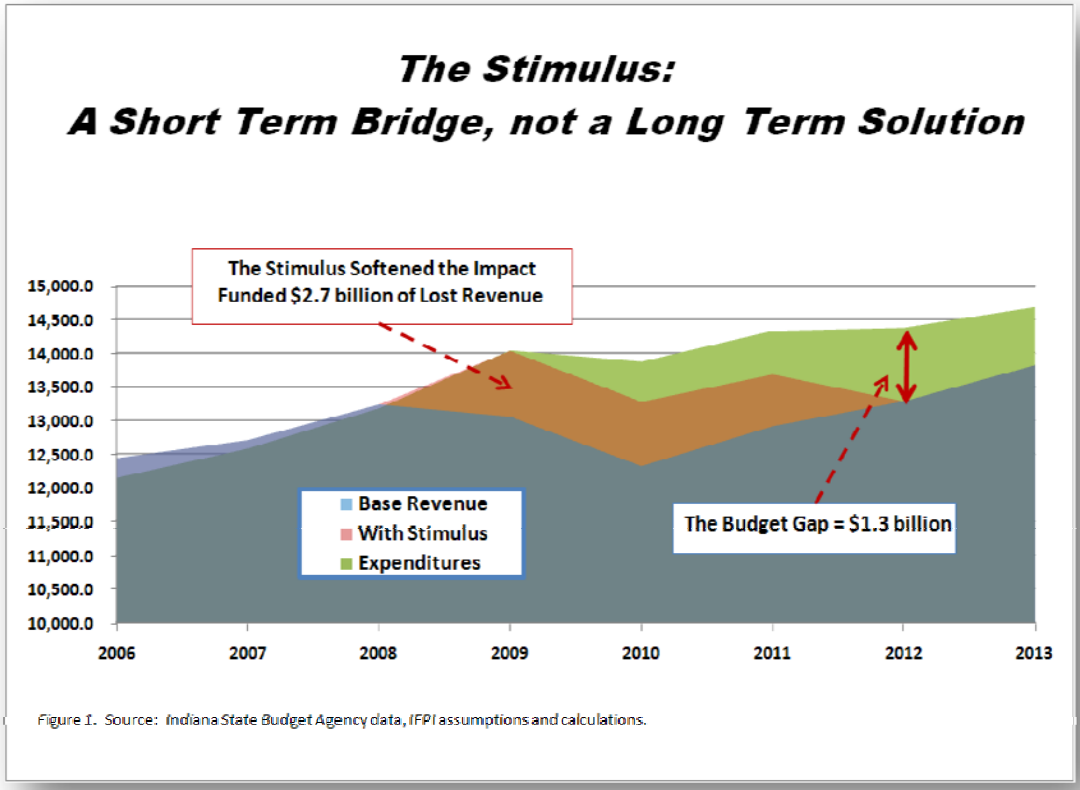


Figure 1 shows how the federal stimulus affected Indiana's budget. The orange area in the middle of the chart represents the stimulus as filling the gap between revenue (the blue area) and spending (the green area, which is hidden behind the revenue prior to and during 2008 and behind the stimulus in FY 2009). The chart shows that when the recession reduced revenue by 1.1 percent in FY 2009 and by 5.8 percent in FY 2010 the budget was no longer viable.

Indiana's share of the federal stimulus funds helped close the gap in FY 2009, giving the governor time to do budget cutting. Expenditures in FY 2010 were $850 million less than in FY 2009 and nearly $1 billion less than budgeted. The governor has said he intends to continue to constrain spending in 2011. The spending increases shown on this chart in Fiscal Years 2012 and 2013 are attributed to unavoidable increases such as pension obligations and Medicaid mandates.

The structural deficit was not caused by excessive spending. It was caused by declines in revenue. Revenue collections in FY 2009 were about $1.4 billion less than forecast when the budget was passed.

To put the state's declining revenue another way, it's like a truck going fast down a hill. But this hill is steep and the load is heavy. The stimulus money acted as a brake down this steep recessionary hill. When the federal bailout ceased, the truck gained speed on the still-steep hill. The governor's budget cuts have acted as an escape ramp, allowing the state to avoid fiscal calamity, but that ramp is getting short. The stimulus and the cuts have helped the situation, but the real problem is declining tax revenue, which is the root cause of the state's structural deficit. This recessionary ride will remain challenging until revenue recovers, either through economic growth or higher taxes, or other actions further reduce spending.

Plenty of Company on This Hill

According to the Center on Budget and Policy Priorities, 46 states have faced budget shortfalls in their 2009 and/or 2010 budgets. The shortfalls dwarf those faced in the aftermath of the 2001 recession. In 2004, state budget gaps totaled $80 billion, while the shortfalls exceed $190 billion in 2010.[4] The Center estimates the combined gap to be $144 billion in 2011. The National Conference of State Legislatures estimates the 2011 gap to be $83.9 billion, larger than states have faced following any recent recession.[5]

Indiana is no different. The revenue and expenditure impact has been substantial and difficult. Indiana entered the 2010 fiscal year with total combined balances of $1.4 billion. The state used nearly $600 million of reserves during the fiscal year, leaving $830.7 million in the bank. The State Budget Agency projects that it will use an additional $642.7 million of reserves in FY 2011, leaving the state with just $118 million. Putting that number in perspective, the state support for local public schools is more than $500 million *per month*!

The bottom line is that Indiana faces a structural budget deficit of more than $1.3 billion entering the next biennial budget, which will be developed during the General Assembly's next session and take effect on July 1, 2011.

Defining the Deficit

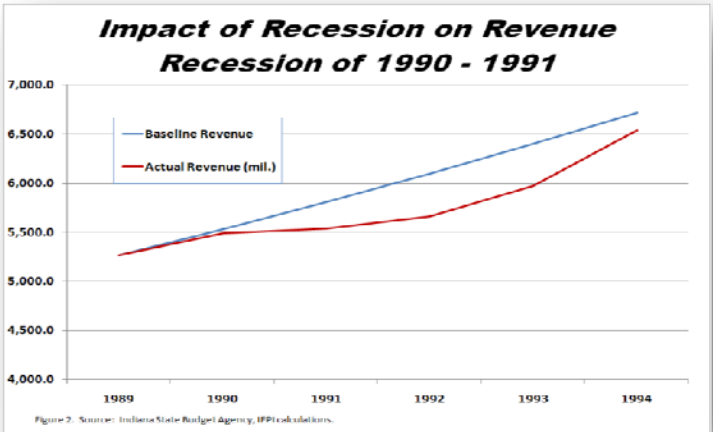
A $1.3 billion budget gap represents nearly 9 percent of the state's 2010 revenue collections. Put another way, the $1.3 billion budget gap is equal to the combined appropriations for most of what people think of when they think of state government. (Table 2)

	in millions
General Government	311.5
Correction	693.3
Other Public Safety	102.4
Conservation & Environment	87.2
Total	1194.4

Table 2. Source: Indiana State Budget Agency

In addition to state prisons, state police and state parks, this total includes money spent for the General Assembly, the judiciary, tax administration, financial management, human resources, procurement and day-to-day administration, and all other elected officials. In 2004, the IFPI reported the state faced an $825 million structural deficit. Today the gap is nearly one-third higher. What hasn't changed is the choices budget writers face: raise taxes, cut spending or do some of both. Wise, prudent, and creative budget management remains necessary.[6]

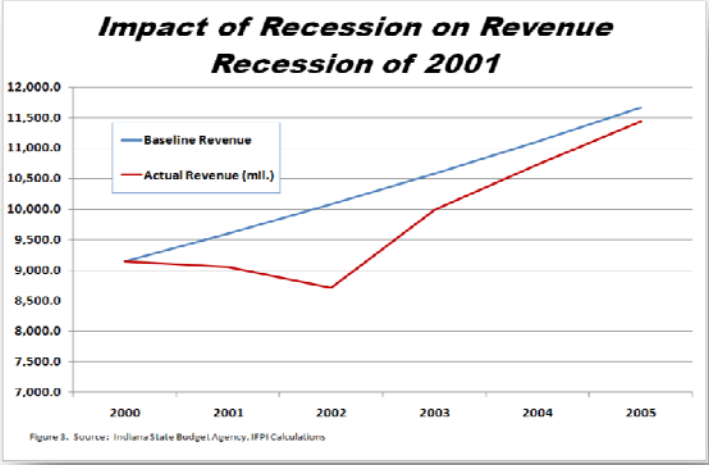
Revenue History



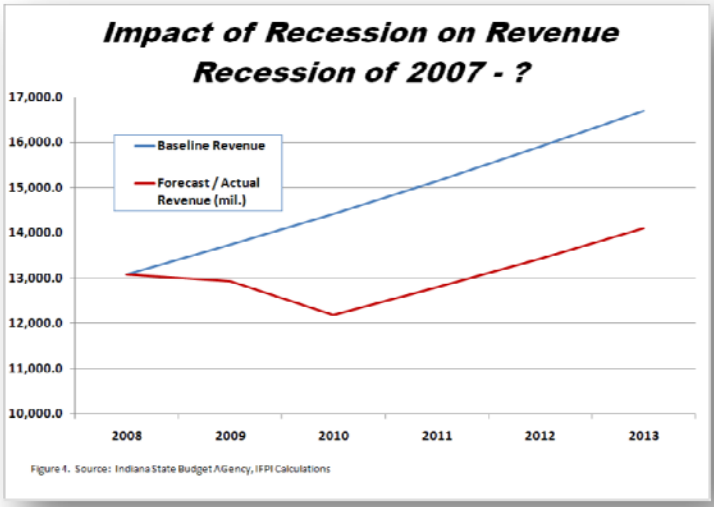
After the 1990-1991 recession revenue collections increased by 0.8 percent and 2.2 percent the next two years. Revenue growth had been averaging more than 5 percent per year, so the gap between the "baseline"[7] and actual revenue collections was substantial

(Figure 2). But, the recovery and economic expansion of the 1990s drove revenue increases well in excess of longer term averages. Add significant new tax revenue from riverboat gambling and actual revenue "caught up" with and exceeded the baseline over time. Deficit defeated.

The recession of 2001 was short, but it had a more severe effect on revenue. For the first time revenue collections declined from one year to the next. Revenue in FY 2001 was 1 percent less than collected in FY 2000 and revenue in FY 2002 was 3.8 percent less than collected in FY 2001 (Figure 3). Indiana responded with a significant tax restructuring that generated some additional revenue to help close the budget gap. With the help of a sales tax increase, year-over-year revenue growth then returned to historical averages, increasing by nearly 6 percent per year from 2004 through 2008. Deficit defeated.



Revenue collections in 2010 were more than $900 million less than 2008. That's twice the $433 million decline in 2002 from 2001.
As the economy worsened during the current recession, the state's revenue forecasting process reacted, reducing total biennial revenue estimates by more than $3.2 billion in three updates over the one-year period beginning in December 2009 (Table 3).



How the Changing Tax Mix Affects State Revenue

Tax restructuring and the economy have affected the mix in significant ways during the last 30 years. The state relied on a roughly equal mix of sales and income taxes for about 60 percent of its revenue in 1979, but those taxes now yield 80 percent of Indiana's revenue. Gambling taxes enacted in 1993 now make up 5 percent of the total. The share of corporate taxes contributing to the state's revenue has slid from 15 percent in the 1980s and 12 percent as recently as 2000, to 5 percent now.

Impact of Recession on State Revenue Expectations

in millions

	2010	2011
Original Forecast - December 2008	13,821.2	14,321.9
Actual FY 2010 / December 2009 Forecast	12,076.2	12,835.7
Reduction from Original Forecast	1,745.0	1,486.2

Table 3. Source: Indiana State Budget Agency.

Indiana's sales tax has, for most of the last 30 years, generated the largest share of tax receipts--49 percent FY 2010. No single tax has ever comprised 50 percent of the state's total revenue. Indiana's income tax became more important in producing revenue during the 1980s and 1990s. Its share of the revenue total has grown from about 25 percent to more than 40 percent in the late 1990s and early 2000s. The

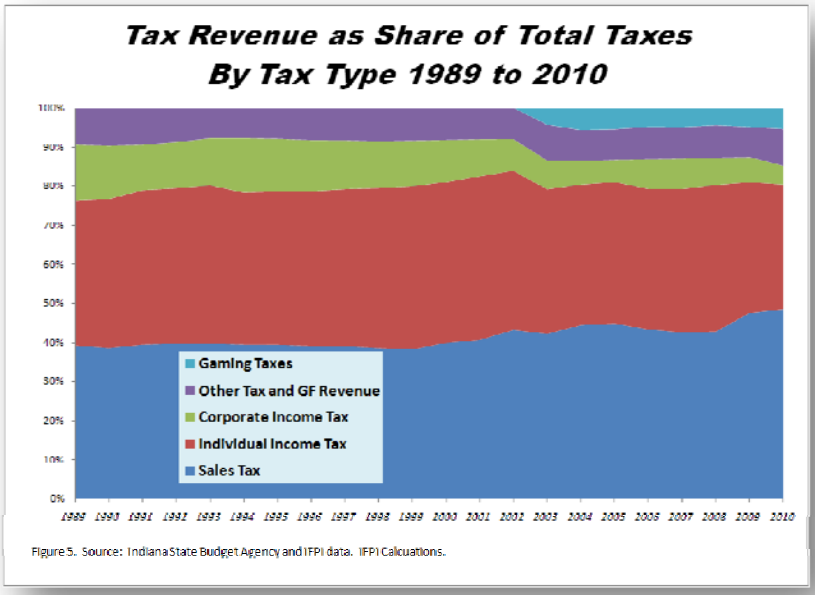


Figure 5. Source: Indiana State Budget Agency and IFPI data. IFPI Calculations.

recession and its accompanying effect on employment and the financial markets, however, has driven the income tax portion of revenue down to only about a third of the total in 2010.

The impact of the changing tax mix is difficult to measure. Most observers generally agree that sales taxes are more volatile – react more to changes in economic conditions – when exemptions such as for clothing, food, and services are present. In recent years, the individual income tax has become more volatile because the increased use of 401(k)s and other individual retirement vehicles brought middle-class America into the financial markets. In addition to investing for retirements, many of these individuals received capital gains incomes. With the recent volatility in the financial markets, the income to individuals and businesses become more volatile, as did individual income tax collections.

In Indiana, budget writers should keep the state's reliance on sales and income taxes and the exemptions, credits, deductions, and exclusions that narrow the tax bases, in mind as they choose to adjust, or not to adjust, tax policy as part of closing the structural deficit.

Expenditure History

Expenditure patterns have changed in Indiana, too. Total appropriations were about $6 billion in 1991. Of that amount, 41 percent went to support local public schools, 16 percent went to higher education, 20 percent funded Medicaid and other health and social service programs, and 10 percent went to property tax relief (Figure 6). Most people would consider each of these to be important functions of state government and they made up about 89 percent of the budget in 1991.

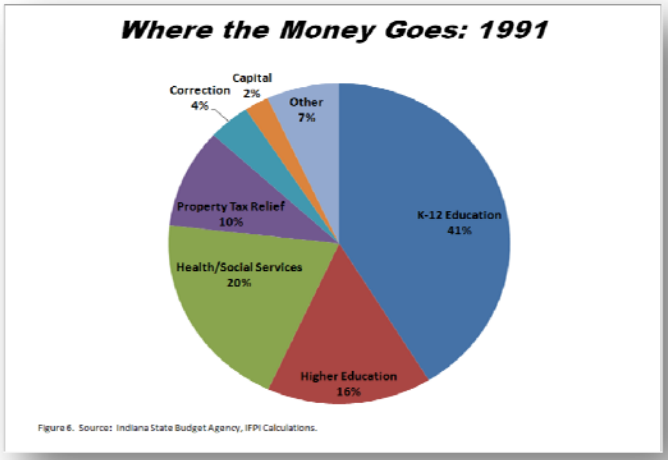


Figure 6. Source: Indiana State Budget Agency, IFPI Calculations.

In 2001 the changes were marginal but important. Support for local public schools remained unchanged as part of the total budget at 41 percent. But property tax relief and public safety, particularly prisons, took larger shares of the budget, at 12 percent and 5 percent, respectively (Figure 7). Spending shares for higher education and health and social services declined.

The tax restructuring of 2002 and property tax reforms of 2008 have significantly changed the proportionate shares of funding for the major state government functions. By FY2011, appropriations for local public schools increased by a third to 54 percent of the budget. Higher education's share dropped to 12 percent while the share of funding for health and social service programming increased to 21 percent (Figure 8).

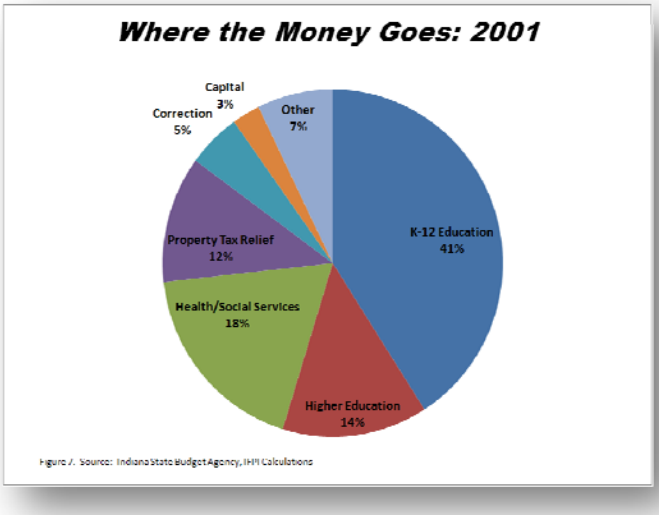


Figure 7. Source: Indiana State Budget Agency, IFPI Calculations

Elimination of the appropriations for property tax relief is proportional to the increase in local public school funding. HEA 1001(ss)-2008 removed direct appropriations for local property tax relief but increased the state appropriation to local schools. The state now supports 100 percent of the general operating costs of K-12 public schools statewide.

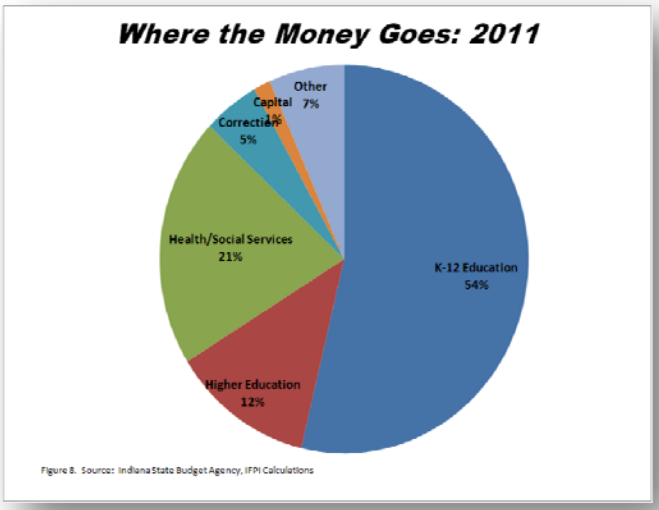


Figure 8. Source: Indiana State Budget Agency, IFPI Calculations

None of the categories, including K-12 education, escaped the budget-cutting knife the governor has wielded since the recession began. Table 4 lists several of the actions his administration has taken since the fiscal 2010-2011 budget was approved in 2009. Over four years, spending has been reduced by a total of nearly $3 billion, nearly 10 times more than the largest previous single-year reversion of $323.4 million in FY2003.

Budget and Cash Management Tactics Used by Governor Daniels and State Budget Agency in Response to Recession	
Delay or Cancellation of Numerous Capital Projects	
20% cuts to State Government Agencies	
Higher Education - 6% of biennial state funding for universities	
K-12 School Formula – 4.5% of CY 2010 School Formula	
Transfers of Unneed and Unused Dedicated Fund Balances	
Total Reversions and Balance Transfers in fiscal years 2008, 2009, 2010,and 2011 (est.) [in millions]	$2,928.90

Table 4. Source: Indiana State Budget Agency

The governor's administration has done much to manage through this recession, however many of the tactics used are one-time in nature. The General Assembly, through the budget-writing process, will have a difficult time allocating the state's scarce revenue for Fiscal Years 2012 and 2013 without some creative thinking and tactics.

Braking Hard: The Next Budget

The 2012 Fiscal Year Base	
2011 Appropriations	14,126.6
Teacher's, Police & Firefighter Pensions	85.0
Medicaid & Other Health Care (from Medicaid Actuary forecast)	300.0
Other Unavoidable Increases	75.0
Total	14,586.6

Table 5. Source: State Budget Agency, IFPI estimates.

The starting point for the biennial 2012-2013 budget is the expenditure base. In past years, the common practice was to begin with the last budget's appropriations and build from there. But, as the earlier analysis shows, this is not a normal year. To determine the base for the fiscal 2012-2013 budget we begin with the FY2011 appropriation, but we won't "build" from there. There are only three areas, in fact, where increases are unavoidable – at least for budget-planning purposes: pensions for teachers, local police and firefighters; Medicaid[8] and other health care related expenditures; and adjustments to appropriations dictated by federal mandates.[9]

Totaled, that spending base is $14.6 billion and is notable for what it does not include: additional money for local public schools or for higher education, or any of the general government activities funded in the budget. The majority of state government agencies, per Budget Agency instructions, have experienced a 15 percent or more cut in 2011 budgets. None of those cuts will be reinstated in the base calculation. The $150 million reduction taken from higher education appropriations in FY2010 also is not restored.

To complete the determination of the base from which the next budget will be developed, we need to develop an estimate of the revenue base. We begin with the base revenue collections for FY2010 minus the federal stimulus funds. Balances transferred from dedicated funds are not considered part of the base, so revenue only from currently enacted taxes and fees are included.

The state revenue forecast estimates that tax collections in FY 2011 will be $12.8 billion. An ongoing reimbursement from the federal government for hospitals that serve a disproportionate share of indigent patients and a fee charged to nursing homes bring the revenue base to $12.9 billion.

The state has not yet forecast revenue for fiscal years 2012 and 2013; that forecast will be done in December. A conservative revenue estimate is reasonable, since there is no official forecast yet and the effects of the recession linger. Since year-over-year revenue declined 1.1 percent and 5.8 percent in fiscal years 2009 and 2010, it is difficult to project much of an increase in the 2011 forecast. In the 10 years ending in fiscal 2010, the state's revenue grew at an average rate of 2.9 percent. That rate is positive, but not as robust as the current forecast for 2011 of 5.3 percent, so we'll use the lower rate to determine the base.

The Structural Deficit in Anticipation of the 2012 - 2013 Budget

The Revenue Base		13,282.9
The Expenditure Base		14,586.6
The Structural Deficit		(1,303.7)

Table 6. Source: State Budget Agency, IFPI Calculations

The New Normal

For the past 30 years state government elected officials could rely upon the economy to recover in a fashion that meant an average revenue increase of about 5 percent—or a little more—per year. And when economic expansion was prolonged and healthy, as it was during the 1990s, the state enjoyed large surpluses.

Recent economic turbulence and the likelihood of an extended recovery period combined with changes in the state's revenue mix and expenditures may signal a "new normal" is upon us. Conventional wisdom developed over many budgeting cycles may have been reset.

- The new normal: Unemployment at 7 percent, 8 percent or even 9 percent through 2012, 2013 or possibly 2014.

- The new normal: Stagnant state revenue growth.
- The new normal: A state commitment to fully fund the classroom activities for our children.
- The new normal: A $1.3 billion structural deficit.

The definition of budgeting, however, has not reset. Budgeting is the allocation of resources made increasingly scarce by the recession. Budget writers still have choices and decisions to make. The new normal may make those choices less palatable and the decisions harder, but they still have a list of options from which to determine the state's spending priorities.

The choices are:

- Raise taxes or tax rates.

The General Assembly increased the sales tax rate twice, from 5 percent to 6 percent in 2002 and from 6 percent to 7 percent in 2008. At 7 percent, Indiana's sales tax rate is among the highest of those states with a sales tax. There has been discussion regarding the inclusion of services in the sales tax base, including by the IFPI,[10] but the General Assembly has not acted to expand the base.

It may be time, indeed may be necessary, to reexamine which services the state should provide—just as the state has asked local government to reexamine and restructure itself.

Indiana has not increased its individual income tax rate since 1987, when the rate went from 3 percent to 3.4 percent. Local option income taxes have been enacted since that time, so a taxpayer's total income tax rate depends upon the decisions of local elected officials. In some counties, which used the proceeds mainly to pay for property tax relief, the effective rate is getting high. The combined rate of state and local income taxes in Pulaski County, for instance is 6.53 percent, and in Jasper County it is 6.45 percent.

- Cut spending.

The governor already has cut spending significantly. Spending decisions affect the services taxpayers and citizens need and want. The General Assembly will be looking long and hard for efficiencies in delivery of services as well as identifying those which could be reduced or eliminated. It may be time, indeed may be necessary, to reexamine which services the state

should provide—just as the state has asked local government to reexamine and restructure itself.

- A combination of tax increases and spending cuts.

This is the politically obvious path that has been used many times in Indiana and likely will be used again.

- Other creative budget management tactics.

Tax revenue should rebound, but it is unclear when or at what rate of growth. The federal stimulus provided funding for appropriations which, in practical terms, gave the state some time for revenue to recover and to make other decisions as necessary.

Controlling the rate of spending growth will bring the budget back into balance over time (Figure 9). But desperate times often lead to desperate measures. Techniques, such as payment delays to schools, for instance, could help bridge the gap between now and when balance is restored.

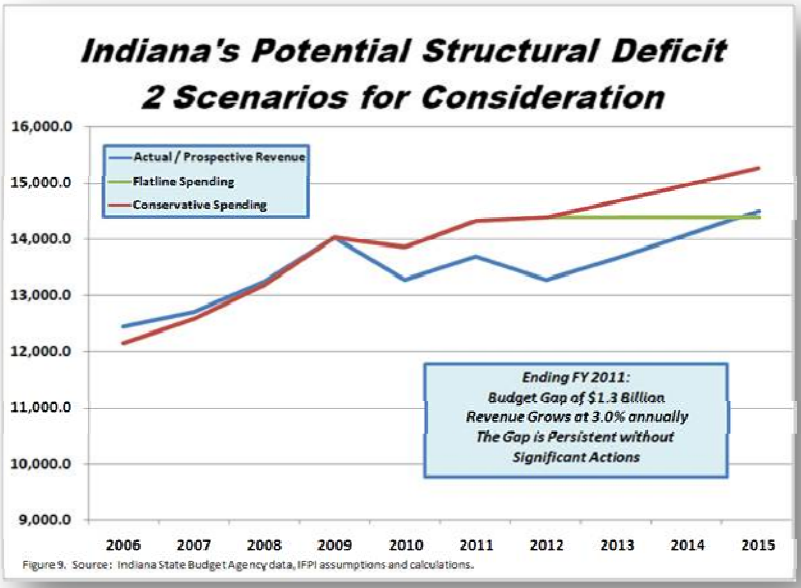


Figure 9. Source: Indiana State Budget Agency data, IFPI assumptions and calculations.

The IFPI reported on many of these techniques and how the state utilized them in managing through the recessions in the early 1980s, the early 1990s, and 2001. While the tactic is tempting, it's important to note that the state didn't catch up on all payment delays related to the last recession until 2009. The governor has taken a hard line against these techniques. This likely would become a major point of contention if the General Assembly includes payment delays in the state budget.

Conclusion

Indiana's budget writers may face a new normal. The state's tax revenue environment may have changed permanently. The income tax has become much more unstable and the reliance on the sales tax with its much eroded base is at its highest level ever. The General Assembly's actions over the past few decades have come together to perhaps permanently change the services and programs funded and delivered by state government. Local public school funding has always been considered the most important use of state tax revenue, but the state now has the responsibility for all classroom and instructional related activities, comprising well over half of the state's budget.

This new reality is accompanied by the stark reality of a $1.3 billion budget gap. That gap, as shown in this report, is not the result of irresponsible spending. It was not caused by the end of federal stimulus funding. Instead the economic realities of the most severe recession since the Great Depression has reset to 2005 levels the tax revenue Indiana relies upon to fund its budget.

The governor and the General Assembly face the brutal and formidable task of bringing the budget back into balance without overburdening taxpayers, shorting education or those who rely upon the state for assistance and services.

Deft driving and a little help from the federal government have kept Indiana's fiscal truck from crashing down a recessionary cliff. But there are many miles left before we reach the valley of economic good times. The state's budget writers better drive carefully.

Postscript: Local Government Budgets

Local governments in Indiana face budget challenges similar to the state's. Property tax reforms – including the property tax rate caps – have constrained and limited property tax revenue. At the same time, lower local option income tax distributions, negatively affected by the recession, contribute to budget shortfalls. The IFPI will issue a report in the coming weeks that addresses the property tax caps and their effect on the financing of local government services.

State government enacted tools for local governments in anticipation of potential challenges created by the property tax caps. These include additional funding mechanisms via local option income taxes, but the opportunities for consolidation and streamlining local governments found in the Kernan Shepard recommendations should get a second look.

[1] A reversion is the return of dollars to reserves as a result of not spending money that the General Assembly appropriated in the budget.

[2] Indiana State Budget Agency. Combined Statements of Estimated Unappropriated Reserve, FY 2009 http://www.in.gov/sba/files/FY2009_Closeout_Rpt_Summary.pdf and FY 2010 http://www.in.gov/sba/files/Surplus_Statement_7-16-10.pdf.

[3] Indiana State Budget Agency.

[4] "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery," Center on Budget and Policy Priorities. http://www.cbpp.org/cms/index.cfm?fa=view&id=711

[5] "An Uphill Battle for State Budgets," National Conference of State Legislatures, July 27, 2010. http://www.ncsl.org/default.aspx?tabid=20889

[6] "Indiana's Fiscal Condition – Hard Questions, Tougher Decisions," Indiana Fiscal Policy Institute. July 2004. http://www.indianafiscal.org/docs/Bulletin2004-1.pdf

[7] Baseline, for the purpose of this report, is what revenue collections or expenditures would have been had the increases been consistent with longer term averages. Said another way, the baseline is what would have happened had there not been a recession.

[8] Medicaid increases include impact of the phase out of the enhanced Federal Match (FMAP) under ARRA during FY 2011.

[9] Sources: State Budget Agency Fiscal Year End Closeout Documents. The IFPI estimated the unavoidable increases based on conversations with the Budget agency and General Assembly fiscal staffs. .

[10] "Sales Taxation of Services in Indiana. Concepts and Issues." Indiana Fiscal Policy Institute, 2009. http://www.indianafiscal.org/docs/Sales-Taxation-Services-Indiana.pdf