



Fiscal Policy

BRIEF

October 1997

Indiana's Fiscal Position in 1997: Weathering the Good Times

Indiana, like most states throughout the nation, is enjoying the fiscal fruits of a booming national economy. To most observers managing state finances when the "good times are rolling" seems a snap. In actuality, protecting appropriate reserves and managing a state's expenditure demand in order to avoid building an unsustainable budget base is anything but child's play. Of course, the proof as to how well the task has been accomplished is delayed as long as the good times last. The question on the minds of state budget directors and legislative leaders across the nation is, "when will the next economic shock hit?" How policy makers answer that question is revealed by their willingness to set expenditure targets in excess of long term revenue growth and as a result reduce states' fiscal cushions.

Indiana's Current Fiscal Position

Indiana is positioned as strongly as any state in terms of its balances and reserves. According to the National Conference of State Legislatures, the average for all 50 states for year-end balances as a percentage of general fund expenditures is 7.3%, with Indiana ranked second at 19.6% (an early estimate). Indiana State government finished fiscal 1996-97 last June 30th with General Fund (GF) and Property Tax Replacement Fund (PTRF) revenue collections at \$8,044.6 million for the year. This level represented a 6.3% increase over the prior year's actual revenues, higher than the 5.1% rate forecast in only April of this year. Actual expenditures for FY 1997 grew by 9.8% over the 1996 level.

The Economy

The nation's economy grew at an annual inflation adjusted rate of 4.9% in the first quarter of 1997 and followed up with a 3.3% rate of growth in the second. Consensus forecasts are predicting at least a 3.5% real growth rate for all of CY 1997 and approximately 2.5% for 1998. The U. S. unemployment rate stood at 4.9% through August of 1997, the fifth month at a rate of 5% or less, with Indiana's rate at 3.3%. In spite of low unemployment, inflation seems to be well under control as measured by both the GDP deflator and the Consumer Price Index, which remain at annual rates that are under 3%.

State Revenues

The best measure of a state's average revenue production is the annual rate of growth during an entire business cycle, barring any tax changes.

Indiana's GF and PTRF revenues grew at an average annual rate of 5.3% from FY 1989 through FY 1997. During the past four fiscal years, the recovery part of the business cycle, the State's operating revenues have increased at an average rate of 7.5% per year. While it is unlikely that Indiana will see that high level of growth this late in the business cycle, revenues should increase annually in the range of 5.0% to 6.0% until the next recession begins.

Prudently Reducing State Balances

One of the perils of managing state finances in a fiscally prudent manner is the resulting large balances that attract taxpayers', voters' and lobbyists' attention. Unfortunately, the reduction of balances, if done the wrong way, can make future tax increases a probability and in the end cause more problems than their presence.

Indiana sits poised in just such a position as it prepares for the 1998 "short" legislative session. If no spending occurs in the short session, and if revenue collections achieve a conservative 5% per year growth through this biennium, the State will enter the next biennium (and millenium) prepared to weather a mild recession without raising taxes, should one occur. Assuming revenues stay flat in the first year of the recession and grow at only 3.5% in the subsequent year, the State would end the next biennium with balances and reserves at 11% of GF and PTRF revenues. (Demonstrated in Table 1.)

Table 1
State GF and PTRF Combined Balance
Rev Growth at 5% and Budgeted Approp's thru FY 1999
Recessionary Reduction in Rev Begins in FY 2000

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001
Total Revenues	\$ 8,044.6	\$ 8,446.8	\$ 8,869.2	\$ 8,869.2	\$ 9,179.6
Total Exp's	7,931.2	8,439.9	8,825.7	9,267.0	9,730.3
Operating Surp/(Def)	113.4	6.9	43.5	(397.8)	(550.7)
Add: Beg Balance	1,024.8	1,138.2	1,145.1	1,188.6	790.7
End GF Balance	\$ 1,138.2	\$ 1,145.1	\$ 1,188.6	\$ 790.7	\$ 240.0
Est. RDF Balance	466.1	475.1	492.6	512.2	530.1
Tuition Reserve	240.0	240.0	240.0	240.0	240.0
Total Avail. Balances	1,844.3	1,860.2	1,921.2	1,542.9	1,010.1
Tot Bal's % Rev's	22.93%	22.02%	21.66%	17.40%	11.00%
Revenue Growth		5.0%	5.0%	0.0%	3.5%
Expenditure Growth		6.4%	4.6%	5.0%	5.0%

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However, if in the 1998 legislative session an additional \$290 million in either tax cuts or spending increases were enacted, as shown in Table 2, a very different outcome would result. In that case, FY 1999 would end with an operating deficit (expenditures in excess of current year revenues) of \$245.9 million. The State would also be forced to either raise an additional \$500 million in taxes or make spending cuts in an equivalent amount prior to the end of the 1999-2001 biennium.

Staying the Course

Indiana policy makers, both legislative and executive have exercised a great deal of prudence in managing the State's rapidly growing resources during the past three years. As an example, appropriations of \$300 million have been made for teachers' pensions (payments in excess of the original legislative commitment to the Pension Stabilization Fund), which will ease the demands on State appropriations in the next decade and at the same time will not increase the expenditure base.

However, State spending as a percentage of Indiana Personal Income has grown from 5.5% in FY 1995 to a projected 6.1% in FY 1999, equivalent to the level of spending seen immediately before the last recession.

Recommendations

1. **Pension Investments:** If additional resources arrive via adjustments to the current revenue forecast, policymakers would do well to consider adding to the Pension Stabilization Fund (a part of the Teacher's Retirement Fund) to reduce future benefits' payout pressure. Second, cities and towns across the State continue to struggle with unfunded liabilities in their old police and fire pension plans. An additional appropriation to the reformulated M fund within the Pension

Relief Fund, would greatly assist local governmental units and at the same time would not add to the ongoing expenditure commitments of State government.

2. **Reserve Adjustment:** The State's Rainy Day Fund (IC 4-10-18-10) was established with a cap of 7% of current year GF revenues. Because the GF and the PTRF are now effectively one fund for purposes of State fiscal management, a cap of 7% of both funds combined would provide the most reasonable fiscal safety net.

Table 2
Combined GF & PTRF Balance
Alternative Scenario with
Additional Appropriations in 1998

	FY 1999	FY 2000	FY 2001
Total Revenues	\$ 8,869.2	\$ 8,869.2	\$ 9,179.6
Total Exp's	9,115.1	9,570.8	9,549.4
Operating Surp/(Def)	(245.9)	(701.7)	(369.8)
Add: Beg Balance	1,145.1	899.2	197.5
End GF Balance	\$ 899.2	\$ 197.5	\$ (172.3)
Est. RDF Balance	492.6	512.2	530.1
Tuition Reserve	240.0	240.0	240.0
Total Avail. Balances	1,631.8	949.7	597.8
Tot Bal's % Rev's	18.40%	10.71%	6.51%
Revenue Growth	5.0%	0.0%	3.5%
Expenditure Growth	8.0%	5.0%	-0.2%

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