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Setting Fiscal Integrity Standards—Three Benchmarks The Senate Budget

Mark D. Brown
Research Director

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The Indiana Senate passed its proposed state General Fund Budget (Budget) on April 11th by a vote of 36 -13. In a somewhat unusual step the on same day, the Senate passed a separate bill containing several significant K-12 school funding and local government funding provisions that are linked with the Budget. In addition, provisions in a third bill regarding the use of revenue from limited gaming at the state's two horse racing tracks are also linked to the Budget. Finally, the Budget Committee, on April 16th, received the revenue forecast update.

Combined, these events require attention as the Indiana Fiscal Policy Institute (IFPI) evaluates the Senate Passed Budget. A substantial policy shift in the state's use of its resources to subsidize funding for K-12 education and local governments and a reduction in the revenue forecast impact our evaluation. However, we will still employ the three benchmarks we used for the Governor's initial proposal and the House of Representatives' passed budget. Those three benchmarks are:

- 1) The Budget must be structurally balanced,
- 2) The Budget must reverse all remaining payment delays, and
- 3) The Budget must set aside a combined surplus of at least 10% of operating revenue – or about \$1.35 billion – at the end of the biennium.

A Complex Senate Budget Plan with an Updated Revenue Forecast

The Senate Budget was based on the revenue forecast of December 14, 2006. The Budget would spend \$13.0 billion FY 2008 and \$13.3 billion in FY 2009. Based on the revenue forecast information the Senate had as they developed the budget proposal, the Budget was structurally balanced, it reversed all remaining payment delays, and increased total reserves to just over \$1.1 billion, or 8.3% of operating revenue.¹

Table 1. Total Expenditures, Structural Surplus or (Deficit) and Combined Surplus Balance
(Senate Passed Budget Based on Revenue Forecast December, 2006)

	2007	2008	2009
Total Expenditures	12,651.0	13,015.1	13,299.5
Structural Surplus / (Deficit)	155.6	191.3	296.7
Ending Combined Balance	886.6	839.4	1,124.5
Balance as Percent of Revenue	7.1%	6.5%	8.3%

Source: Indiana State Budget Agency, IFPI Calculations

The Budget, as it passed out of the Senate, met two of the three benchmarks, but fell short of the minimum balance benchmark of \$1.35 billion.

However, the April 16th revenue forecast update lowered projected revenue by \$150 million. The forecasters reduced overall revenue growth in all three years of the forecast period.² These projected revenue growth rates are the slowest since the April 2001 revenue forecast update entering the final days of the FY 2002-2003 budget debate.

For those with short memories, the FY 2002 – 2003 biennium was the worst – in terms of revenue results – in the history of the State. As a result of the 2001 recession, revenue collections *declined* in both FY 2002 and FY 2003, by 1.0% and 3.8% respectively.

Table 2. Comparison of Revenue Forecasts			
Total Revenue Percent Increase Over Prior Year			
	2007	2008	2009
December 14, 2006	2.5%	4.2%	4.5%
April 6, 2007	2.3%	3.9%	4.4%
Amount of Reduction	\$ 22.8	\$55.8	\$71.2

Source: Indiana State Budget Agency

Returning to the impact of the Revenue Forecast update on the FY 2008 – 2009 budget, what was a budget that required much discipline to meet the three benchmarks became an even “tighter” one.

The expenditure side of the Senate Budget was not changed by the revenue forecast; but that forecast reduced the total surplus balance by \$150 million, to approximately \$975 million. By way of comparison, the Governor’s budget end-of-biennium combined balance would have been reduced from \$1.2 billion to \$1.05 billion and the House passed budget combined balance would have been reduced from \$921 million to \$771 million.

Table 3. Condensed Surplus Statement			
(Senate Passed Budget Based on Revenue Forecast December, 2006)			
	2007	2008	2009
GF / PTRF Balance at July 1	410.7	70.5	(48.1)
Current Year Resources (from April 16, 2007 Forecast Update)	12,310.8	12,896.5	13,493.9
Total Resources	12,721.5	12,967.0	13,445.8
Appropriations	12,246.0	13,032.1	13,316.5
Other Expenditures, Adjustments, & Reversions	405.0	(17.0)	(17.0)
Total Net Expenditures	12,651.0	13,015.1	13,299.5
General Fund Reserve Balance at June 30	70.5	(48.1)	146.3
Other Reserve Balances	793.3	808.8	828.3
Combined Balances	863.8	760.8	974.7
Combined Balances as a Percent of Revenue	7.1%	5.9%	7.2%

Source: Indiana State Budget Agency, IFPI Calculations.

Senate Budget Priorities

While the Senate Budget proposed dramatic changes in how the state distributes over \$2.0 billion dollars of property tax subsidies, its programmatic funding priorities are similar to the Governor’s budget (see Table 3). Higher education receives total funding increases of about

5.0% per year and large increases in funding to pay debt service on capital building projects approved in prior budgets. The Senate Budget funds the Governor’s request in the categories of health and social services and correction with the exception of the additional Department of Child Services caseworkers.

Unlike the House passed budget, the Senate Budget does not fund Full Day Kindergarten at the amount requested by the Governor.

Another difference in the education budget occurs in the

appropriation for benefits paid from the Teachers’ Retirement Fund. The Senate reduces the General Fund appropriation for benefit payments to retired teachers from a six percent increase to a 5.25% increase each year. To fund this, the Senate Budget requires additional transfers from the Pension Stabilization Fund (within the Teachers’ Retirement Fund). Current analysis shows that this change will not adversely affect the Pension Stabilization Fund and, in fact, is consistent with the original intent. If the resources of the Pension Stabilization Fund allow it, the IFPI would recommend further reduction in the annual percentage increase of the General Fund appropriation.

Medicaid receives the amount it requested, about 5.0% per year. This amount, while consistent with the Governor’s request, does not fully fund the State’s Medicaid Forecast, which estimates total expenditures to increase by approximately 8% in each year of the biennium. Mitch Roob, the Secretary of the Family and Social Services Administration (FSSA) stated that he intends to make the changes necessary to hold expenditures within the 5% appropriation. The IFPI considers this a risky budgeting approach.

K-12 Education Funding and Property Taxes

The majority of the complexity within the Senate Budget comes from the elimination of the Property Tax Replacement Credit and Homestead Credit to fund 100% of the expenditures from local public schools’ General Fund and (eventually) 100% of the Family and Childrens’ Fund. Obviously, this proposal, authored by Senator Luke Kenley, has generated much interest and debate, as it should.

Two years ago, in the IFPI analysis of the enacted budget for fiscal years 2006 – 2007, we characterized the capping of the state subsidies for local schools and governments as a “monumental shift” in policy. It was. And so is Senator Kenley’s proposal.

Under current law, state subsidies to local units of government via property tax replacement credits and state homestead credits are broadly applied; that is, all local schools and all local units of government receive relatively similar shares. Distributions are determined through a

<i>Table 3. Senate Passed Budget</i>		
<i>Percentage Increase in Select Budget Categories</i>		
	2008	2009
Higher Education	5.1%	5.0%
Higher Education - Debt Service Only	19.8%	8.5%
Medicaid	4.8%	4.9%
Health and Social Services	5.1%	2.0%
Correction	4.4%	3.1%
Teachers’ Pensions	5.25%	5.25%

Source: Indiana State Budget Agency, IFPI Calculations.

method that spread the subsidy across all units in relatively proportional shares. The total amount distributed is equal to the total amount of reduction applied to property tax payer's bills.

Senator Kenley's proposal changes the policy from a general subsidy to a focused one. The over \$2.0 billion that had been spread across all local governments and public schools would be targeted to local public schools, the Family and Childrens' Fund, and the Juvenile Incarceration Fund. The rationale is that the State makes most of the decisions that affect the spending levels and therefore, state taxes should be used to pay for them.

To be clear, state Property Tax Replacement Credits (PTRC) and state Homestead Credits reduce property taxes, but they do not reduce the overall tax burden. Likewise, eliminating the PTRC and state Homestead Credits and using those state resources to pay for school general fund levies, Family and Children's fund levies, and Juvenile Incarceration levies will not reduce the overall tax burden.

In both cases, the amount of property tax reduction is replaced entirely by state appropriations. Those state appropriations are funded through state levied taxes, primarily the sales tax and the income tax. Therefore, the historical description of increases in property tax replacement and/or homestead credits as "relief" is misleading. It is a shift of tax burden from property tax payers to sales and income tax payers. There are "winners" in that some tax payers may pay less sales and income taxes than they paid property taxes, but those are offset by "losers" who pay more sales and income taxes than they paid property taxes.

On the local government side, the entire cost of government funded by property taxes will now be paid by property tax payers. There will be no property tax replacement credit or state homestead credit, save a temporary homestead credit.

A final observation about the proposal to eliminate the PTRC and state homestead credit and use those resources to fund public school's general funds, the Family and Childrens' Fund, and the Juvenile Incarceration Fund. It has been characterized as major property tax "reform." It does not reform property taxes. It does shift the use of state dollars from general local government subsidies to subsidies focused on the three specific programs. But it does not significantly change or reduce property taxpayer's tax bills, nor does it significantly reduce overall reliance on property taxes.

There are other provisions in the legislation that allows local units of government to levy local income taxes instead of property taxes. That provision, if enacted, would reduce local government's reliance on the property tax, but the overall tax burden would not decrease.

The IFPI does not intend the above comments to be critical of Senator Kenley's proposal eliminating the PTRC and focusing state subsidies to public schools, the Family and Childrens' Fund, and Juvenile Incarceration. On the contrary, the proposal is a positive policy change. Responsibility and decision making for public school general funds, the family and children's fund, and juvenile incarceration are primarily made by the State. Therefore, funding resources should be state resources, not local property taxes.

However, the underlying property tax assessment system – its practice and administration – remains seriously flawed and is in need of reform.

True property tax reform would improve the underlying assessment system, and would start by determining and recognizing the current inconsistent assessment practice across the state and the inconsistent and inequitable burdens borne by taxpayers and classes of property. True reform would provide for assessed values more reflective of a property’s market value and more consistent across taxpayers’ properties, regardless of the location of their property. True reform would include the elimination of township assessing jurisdictions and a reduced number of local governmental entities.

While property tax reform is not directly linked to the state budget, it needs to happen. If not in this session, soon.

Recommendations for the Enacted Budget

The three IFPI benchmarks still apply:

- 1) The Budget must be structurally balanced,
- 2) The Budget must reverse all remaining payment delays, and
- 3) The Budget must set aside a combined surplus of at least 10% of operating revenue – or about \$1.35 billion – at the end of the biennium.

An updated revenue forecast that reduces total revenue available by \$150 million makes meeting the benchmarks more challenging but, at the same time, makes meeting them even more important. The nation’s – and Indiana’s – economy is at a mature stage. It is now six and one-half years since the end of the 2001 recession, making this expansion the third longest since World War II.

The IFPI recognizes the challenge faced by the House, the Senate, and the Governor as they negotiate the final version of the Budget. The fiscal integrity of the State of Indiana, integrity that will allow necessary investments in Indiana’s future, is at stake.

¹ As has been the IFPI’s practice, we exclude from our analysis legislation “outside” the budget process. Since not all of the revenue producing or appropriation making bills will ultimately become part of the budget at the end, the IFPI makes no effort to decide which will make it and which won’t. There are, of course, exceptions. The K-12 funding changes, the elimination of the property tax replacement fund and state homestead credit, and the temporary state homestead proposals are such exceptions and we have included those impacts in this analysis.

² The forecast period starts with the last months of FY 2007 and includes FYs 2008 and 2009.

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