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## Closing the Books on Fiscal Year 2005: An Improved Outlook, but More Must Be Done

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## CLOSING THE BOOKS ON FISCAL YEAR 2005: AN IMPROVED OUTLOOK, BUT MORE MUST BE DONE

On July 15th, Governor Mitch Daniels reported the State of Indiana's fiscal year (FY) 2005 results. For the first time since FY 2000, the FY 2006 State fiscal outlook showed signs of improvement. The Governor stated his intention to move the State "into a new era of financial responsibility."<sup>1</sup> While the Governor and the General Assembly have taken significant steps toward that goal, revenue growth is forecast to be moderate, and expenditure pressures are high and increasing due to recent budget constraints. Finally, reserve balances remain at historical lows and the State remains unprepared for the next economic downturn.

One year ago, the Indiana Fiscal Policy Institute analyzed the State's fiscal condition at the end of FY 2004 and identified several important fiscal issues that would affect the FY 2006-2007 budget. The Governor and General Assembly responded, closing the structural deficit in FY 2007 by limiting expenditure increases, particularly in education and property tax relief. Thanks to the tightly crafted budget and an improving revenue collection picture, the Office of Management and Budget now projects reserve balances of about 7.4% of revenue (\$921.2 million) at the end of the current budget cycle.

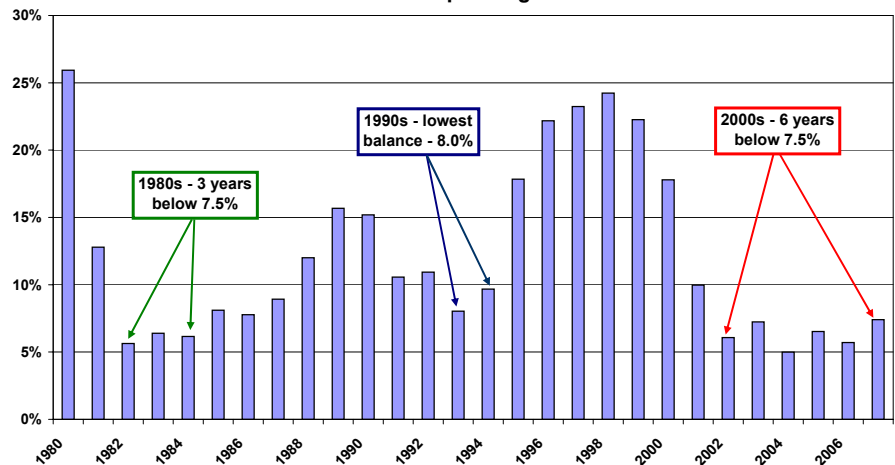
However, those balances mask a still precarious perch. Combined balances grew by over \$200 million in FY 2005 and are projected to grow another \$170 million, to \$921.2 million, at the

<sup>1</sup> "Indiana closes Fiscal Year 2005 books," News Release, Office of the Governor, July 15, 2005.

end of the biennium in June of 2007. However, as shown in Figure 1, these balances remain below 7.5% of operating revenue throughout the biennium. FY 2006 balances will represent only 5.7% of operating revenue. Should the budget projections hold true, the State will have experienced six years of reserve balances below 7.5% of operating revenue by the end of the FY 2006-2007 biennium. These are historical lows, as balances remained below 7.5% for only three years in the 1980s, following the severe, double-dip recessions of 1980 and 1981-1982.

The impact of the last recession on State balances has not only been deep but has been long-lasting. In the 1980s recession, the low

**Figure 1.**  
Combined Reserve Balances  
as Percent of Operating Revenue



Source: Indiana State Budget Agency

point was 1982, with combined balances dropping to 5.6% of revenue. In the 1990s recession, the low point was reached in 1993, at 8.0% of revenue. In the 2000s, balances dropped to 6.1% in 2002 and to 5.0% in 2004. The Budget Agency projects combined reserve balances will only reach 7.4% of operating revenue by the end of the biennium in June of 2007, while the recession will have ended nearly six years

earlier. In contrast, balances were over 12.0% by 1988 and over 22.0% by 1996, points in time reflecting a six year period following a prior recession.

The slow recovery and low balances mean that delayed payments to local governments, schools and higher education institutions most likely will not be reversed during this biennium. These delayed payments are a \$700+ million liability incurred to help the State through the 2001 recession and remain in place four years later. More importantly, the technique, which has been used in each of the last three recessions is, until repaid, unavailable should the economy slow significantly during the next two years.

**Budgetary factors contributing to the risky nature of Indiana’s fiscal condition:**

**Revenue:** FY 2005 was the first year since 1999 that revenue collections exceeded their “budget-based” forecast.<sup>2</sup> This followed a nine year period, beginning in 1992, during which revenue collections exceeded the budget-based forecast every year.

The 2001 recession brought an unprecedented two consecutive years in which revenue collections were less than they had been the previous year. Since 2003, however, revenue growth has been strong. The 13.4% growth

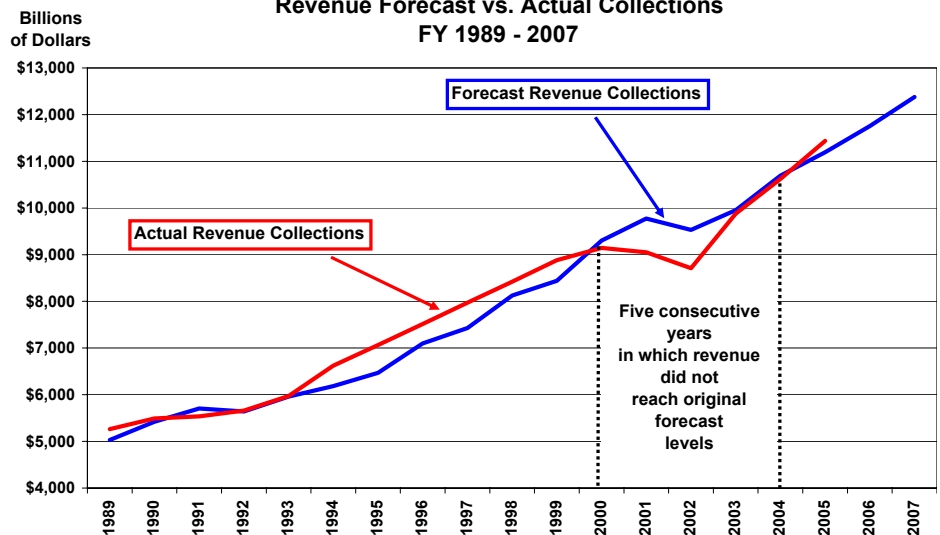
<sup>2</sup> The State’s revenue forecasting process actually projects revenue collections for every fiscal year several times. In this analysis, “budget-based” forecast is the forecast upon which the enacted budget was passed. Over the period from 1989 through 2007, the budget-based forecast would be made in April of the fiscal year immediately preceding the budget biennium. For example, the forecast used to enact the 2006-2007 biennial budget was made in April of 2005.

| State FY Ending June 30 | Percent Growth of Revenue Collections over Prior Year |
|-------------------------|---|
| 2000                    | 2.9%  |
| 2001                    | -1.0%   |
| 2002                    | -3.8%   |
| 2003                    | 13.4%   |
| 2004                    | 7.5%  |
| 2005                    | 7.7%  |

in 2003 is due largely to the tax restructuring package enacted in the 2002 Special Session of the General Assembly.

In contrast to the mid-1990s, when similar revenue growth led to large surpluses, reserve balances remain low. The primary reasons for that are the depth of the impact of the 2001 recession on revenue collections and the inclusion of an \$800 million annual increase in property tax relief in the tax restructuring legislation.

**Figure 2. Revenue Forecast vs. Actual Collections FY 1989 - 2007**



Source: Indiana State Budget Agency

**Expenditures:** For the first time since 1998, and after four years of very tight budget management in fiscal years 2004, 2005, 2006, and 2007, revenue will exceed expenditures in FY 2007.

In spite of anemic revenue growth during and immediately following the recession, the State was able to maintain expenditure growth throughout the period, with the notable exception in 2002. However, without payment delays, expenditures would have grown in 2002, though only by about 0.5%.

The 2006-2007 budget limits expenditure growth to about 3.2% in 2006 and 1.8% in 2007, after adjusting for one-time reversions of capital appropriations. These increases are within the range of average long term revenue growth and should be sustainable, if the economy continues to grow without recession.

Much of the budget's constraint involves the capping of the very property tax relief passed just 4 years ago in 2002. Combined over the two year biennium, expenditures for K-12 education, higher education, and property tax relief increased by only 0.9%, while the rest of the budget increase by 9.7%.<sup>3</sup>

### Conclusion

Looking ahead, revenue collections are forecast to grow at only moderate rates – by 2.8% in FY 2006 (over FY 2005 actual collections) and by 5.3% in FY 2007. Some may suggest that these rates of growth are likely to be met and surpassed, but to do so, the current economic expansion will have to last through the end of FY 2007, at which time it will be nearly six years old. The expansion of the 1990s lasted 10 full years, but it was the longest on record. The length of the average expansion is about five years. While we cannot predict the next recession, history says it is not all that far away, especially in biennial budget terms.

On the expenditure side of the budget, pressure to increase expenditures for K-12 education, property tax relief, as well as Medicaid and other social and health care services will almost certainly increase over the next biennium.

Without question, the State's fiscal condition is better this year than last. The Governor and the General Assembly enacted a budget that

<sup>3</sup> The majority of budget appropriation increases came in the following categories: Medicaid—14.6%, other social services and health—8.2%, teachers' pensions—9.4%, and capital, which includes debt service for state and higher education building projects—16.8%.

**Table 2. Annual Percentage Growth in State Expenditures**

| State FY Ending June 30 | Percent Growth of Expenditures from Prior Year |
|-------------------------|--|
| 2000                    | 7.2%   |
| 2001                    | 4.7%   |
| 2002                    | -3.2%  |
| 2003                    | 10.0%  |
| 2004                    | 4.2%   |
| 2005                    | 2.8%   |
| 2006                    | 4.7%   |
| 2007                    | 1.3%   |

made significant progress toward stability and fiscal health. But they should not be overly comforted, because the State's balances remain and are projected to remain at historical lows while payments delayed to local government, schools, and colleges and universities have not been reversed. To lead us to the new era of financial responsibility, the Governor and the General Assembly have more work to do.

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**April 2006**

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  - Wide inconsistencies in assessment results,
  - Lack of accountability – No one is "in charge,"
  - Structure and processes still reflect a 19th Century culture
- Developed recommendations for improving the property tax assessment system and structure statewide
  - Eliminate Township assessment
  - Strengthen State Oversight and Assistance
  - Require 21st Century data and information system
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- The Evolution of Indiana's Labor Force, 1968-1997
- Graduate Migration from Indiana's Postsecondary Institutions

- The Indiana Workforce: An Employer's Perspective
- Survey of Current Practices in Postsecondary Graduate Retention

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