

Indiana's Fiscal Challenge 2002:

Choosing a Path to Recovery



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Executive Summary

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Indiana's fiscal structure is in need of repair. The state's manufacturing sector is experiencing job losses to an extent not seen in 20 years. Predictably, the state's revenues are showing the effects. The state has lost \$3.7 billion in expected revenue collections to the current recession and could lose more. The biennial budget is almost 2 billion dollars out of balance and the problem, absent intervention, becomes more unmanageable in the next biennium.

While the recession is the near term cause of the state's distress, fiscal policy choices over the past 6 years figure prominently in the drama. Spending from FY 1995 through 2001 grew at a rate 30% higher than revenues. It turned the State's once embarrassingly large balances into ominous deficits. Legislatively and administratively proffered tax cuts (income, sales, and property) have also helped to put the state's fiscal posture in a slump. By FY 2001, annual revenues had been reduced by approximately \$750 million while the impending court-ordered reassessment under a new, market value standard is left to severely threaten taxpayers.

Governor O'Bannon has introduced a plan to deal with the State's budget deficit that some have criticized for its tax increase provisions (cigarette and riverboat admissions). Balanced against the tax increase, the plan proposes reductions in spending of significant magnitude. However, to be successful, the plan must cut \$250 million in projected Medicaid expenditures in this fiscal year and next, while stopping the rampant growth in Medicaid in the years beyond – a feat judged by many to be extremely difficult.

As challenging as the State's situation is in this two-year fiscal window, the next biennium is worse. Simulating the Governor's plan without the new taxes demonstrates how the historic mismatch in spending and revenue during the past 6 years has set-up the fiscal landscape. If no taxes are raised, either \$1.46 billion in additional spending cuts must be found in the FY 2004 and 2005 period or revenue must grow at heroic rates in order for the State to maintain solvency (12.5% growth in FY 2004 and 6.5% in FY 2005).

Findings

1. Indiana's economy has lost nearly as many manufacturing jobs in the past 2 years (53,200 from December 1999 through December 2001) as it did in the past 2 decades (50,529 from 1978 to 1998).
2. The first signs of the coming recession appeared a year before it was declared, in state revenues falling short of monthly targets. By November 2000, Indiana revenues had fallen short of targets for 10 of the previous 12 months.
3. The State of Indiana has lost \$3.7 billion in revenue to the impact of this recession, in FYs 2000 through 2003.

4. According to the National Association of State Budget Officers through the end of CY 2001, 38 states are experiencing budget shortfalls.
5. From FY 1995 through FY 2000, Indiana's revenues grew by 4.8% per year while spending was growing at a 7.5% annual rate. This mismatch was masked by the large balances the state had accumulated during the mid-1990's.
6. The fastest growing budget categories in the FY 1995 to FY 2001 period were **not** K-12 education or Medicaid, which grew at 5.7% and 4.4%, respectively. The **most rapid** growers were: Teachers' Retirement Fund appropriations, Corrections, and Property Tax Relief.
7. Medicaid went from a tame budget category to a monster in a period of about 6 months during CY 2000 as the economy worsened and per patient costs increased. By the FY 2002 and FY 2003 biennium, Medicaid spending is forecast to increase by 12.8% and 13.4% respectively over the two-year period.
8. Tax cuts enacted in the 1997 and 1999 legislative sessions have reduced the state's available revenues by approximately \$750 million a year.
9. From FY 1998 through FY 2001, tax cuts to reduce the impact of property taxes have grown by more than \$550 million dollars annually. All this was accomplished without in any way addressing the reassessment change arriving in CY 2003.
10. Governor O'Bannon's Balanced Budget Plan is dependent for its success on cutting \$250 million in projected Medicaid spending for the FY 2002 and FY 2003 biennium, which is over and above the legal appropriation. Many observers rate this an extremely difficult task.
11. The Governor's Balanced Budget Plan allows **net expenditures** to grow by 6.0% in FY 2004 and 6.1% in FY 2005.
12. If no tax is increased or revenue source is raised, if all of the Governor's Balanced Budget Plan spending cuts are implemented, and if the appropriations increases are held to 3.3% per year, the FY 2004 and FY 2005 biennium is out of balance by \$1.46 billion.

Recommendations:

1. **Long-term trends matter.** Long-term average growth in Indiana's economy has only produced revenues over the past business cycle at a nominal annual increase of approximately 5.4% per year. However, from FY 1989 through FY 2001 the state spent at an annual rate of 6.0% per year. This mismatch was not entirely unforeseen and indicates either a structural deficit or a need to cut spending, (depending on point-of-view). Policymakers can and should base their budgets on realistic expectations of revenue growth over the long-term. If elected officials believe average revenue growth is not sufficient to meet the long-term expenditure requirements of Indiana and its citizens, taxes should be raised. If, on the other hand, elected officials believe spending has been too high, frivolous, or unnecessary, then long-term spending patterns must be constrained and control should be exercised to keep spending in check. *Sound fiscal policy requires balancing the fiscal structure in keeping with both available resources and desirable public expenditure levels.*

2. **“Fiscal policy should drive tax cuts, not the other way around.”¹** While some of the spending choices incorporated in the budgets of the mid-1990’s were clear attempts to invest and avoid future expenditure emergencies, it is by no means clear that the tax cuts enacted from FY 1995 through FY 1999 were based on thoughtful policy direction. The attempt to lower effective property tax costs, while consistent over the period, avoided the impending reassessment crisis in an almost neurotic fashion. *Tax policy decisions need to be made in concert with long term spending and economic development strategies and cannot wisely ignore impending major issues – such as reassessment – that will have such enormous impact on the taxpayer.*
3. **It is important to keep one’s hand on the tiller.** The State of Indiana is a \$16 billion a year entity with a complex and rapidly changing financial structure. Like any large organization, effective financial control is critical to sound management and, if the Enron situation is instructive, to achieving the organization’s goals. Competent and capable management of the state’s finances requires, first of all, well trained, skilled and experienced practitioners within the state’s office of financial control which is the State Budget Agency. Second, there must be a recognition by policymakers of the key role the agency plays in both the day-to-day operations of government and the legislative process. *The State Budget Agency should be funded at levels that allow for a high degree of professional staffing, with maintenance of a bi-partisan professional atmosphere. The proficient monitoring, analysis, reporting, and management of the state’s financial operations and condition depend upon just such a commitment.*
4. **Indiana’s fiscal structure is not a sports car, but it can turn quickly.** From FY 1995 through FY 2000, Medicaid grew at a modest and manageable 3.6% per year. However, in the 6 month period prior to the release of the December 2000 Medicaid forecast, this budget category became a monster growing at double-digit rates. Detailed program and expenditure analysis is the only effective mechanism for providing early warning for these budget surprises. As we recommended in the Indiana Fiscal Policy Institute 1993 Budget Report, the appropriate executive branch focal point for continuing program/expenditure review is the State Budget Agency. *“The role of the budget analyst should...include significant allocation of time to program analysis. Such analysis should always address the questions of whether programs should be retained and, if so, at what form and at what level of resource commitment. Most importantly, the analyses should routinely feed into the process of budget development so that they cannot be ignored when budget recommendations are made.”²* It is time the state followed that sound advice.
5. **Keeping track of a moving target.** Some of the recent documentation of the state’s fiscal condition has been misunderstood by the very stakeholders to whom the communication is directed. The misunderstandings stem from, first, modifications to the manner or format in which the documents are presented over time which make comparisons difficult. Second, there have been changes to legal appropriations’ levels which also introduce uncertainty into the analyses of the state’s fiscal position. *We recognize that it is always important to improve the methods of fiscal communication. We also believe that it is vital to provide documentation to connect new forms and information with prior presentations.*

¹ John Stuart Hall, Arizona Policy Choices, School of Public Affairs, Arizona State University, 1999.

² “The 1993-1995 Indiana State Budget,” Indiana Fiscal Policy Institute, April 1993.