

Indiana's Fiscal Challenge 2002: Choosing a Path to Recovery



Fiscal Policy Report No. 20

January 2002

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January 2002

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Indiana's Fiscal Challenge 2002: Choosing a Path to Recovery

Executive Summary

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.

¹ “The 1993-1995 Indiana State Budget,” Indiana Fiscal Policy Institute, April 1993.

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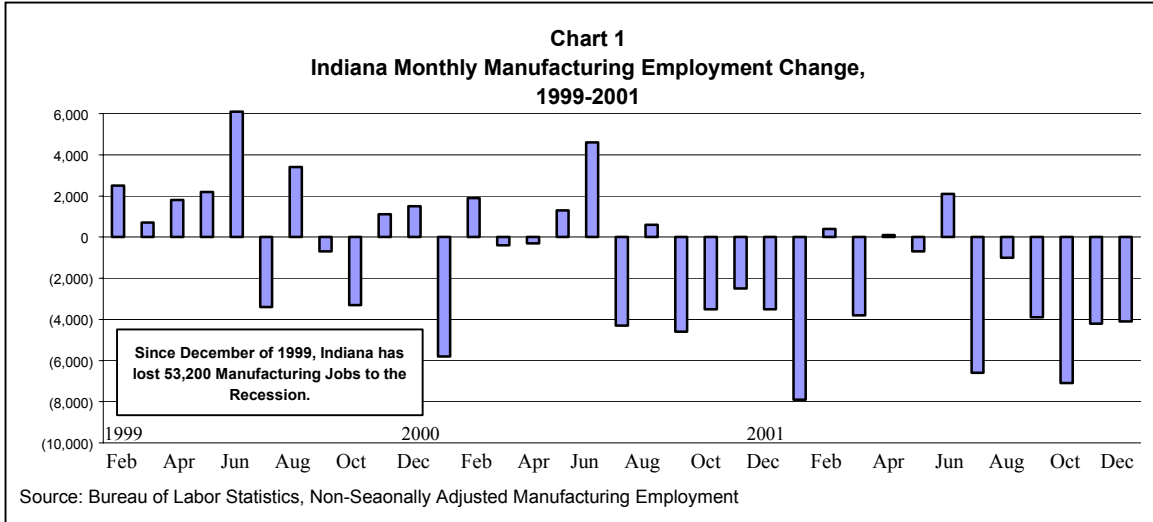
Introduction:

After exactly 10 years of expansion, the nation's economy entered recession in April of 2001. Although it has been a long time arriving, many experts are forecasting this recession to be both mild and short. While the recession came to the nation reluctantly, Indiana was a "leading indicator" of the downturn, a position it shares with several states. By the time the recession was announced in November of 2001, more than 30 states were suffering budget shortfalls that, nationally, totaled more than \$15 billion.

Indiana's budget shortfall is more challenging, already, than the situation the state faced during the 1990–1991 recession. Tax revenue declined for the first time in over 20 years and the budget was "overbuilt" during the long expansion, particularly in FY 1999. Now midway through the 2001-2003 biennium, Indiana finds itself with huge projected deficits and no easy policy alternatives. Governor O'Bannon has responded with his "balanced budget plan" which includes tax increases, spending cuts, and delays of distributions. We will examine how the state has arrived at this point and the real choices facing policymakers seeking to navigate through the economic storm and steer a wise course to recovery.

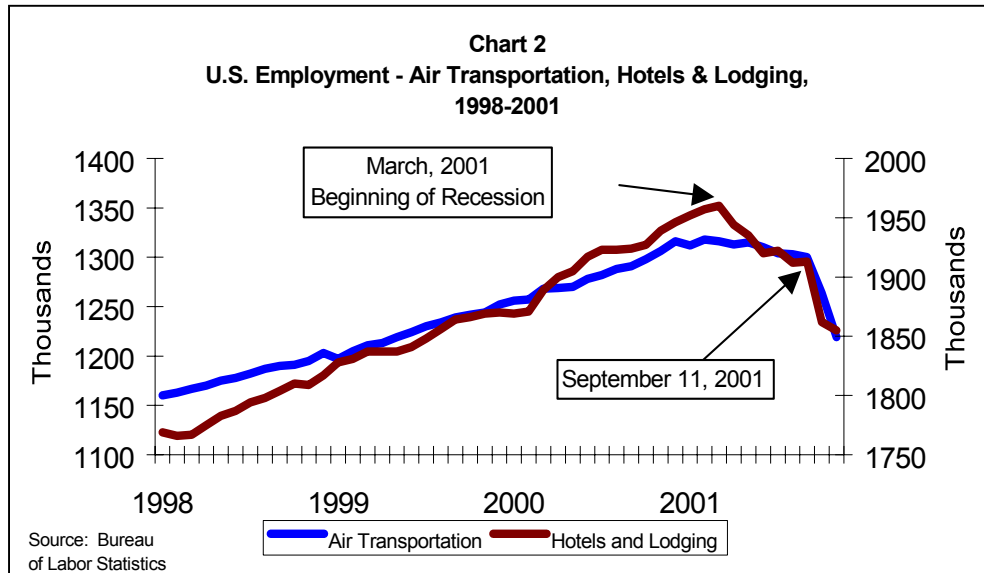
The U.S. and Indiana Economies – A Confusing Outlook:

Table 1. A Confusing Economic Outlook: Positive and Negative Economic Indicators	
Positives	Negatives
<ul style="list-style-type: none"> • U.S. non-manufacturing employment grew until August 2001, beginning to decline in September. • New home sales have continued growing throughout the last year. In contrast, home sales fell dramatically during each of the last 2 recessions. • After spiking for a brief period in January & February of 2000, natural gas prices have fallen. • Crude oil prices peaked in November 2000 and have been falling since. • Even before September 11, Americans continued to purchase autos and light trucks. 	<ul style="list-style-type: none"> • In Indiana, non-manufacturing employment has lagged behind the rest of the U.S. since May 2000. • Manufacturing employment dropped precipitously beginning in July 2000, both in Indiana & across the U.S. • The nation's equity markets, in August 2000, began a decline that has yet to be reversed. • Consumer confidence began to decline in the second quarter of 2000 and fell dramatically in the first quarter of 2001.



The national trends driving this recession began in manufacturing and hit payrolls in Indiana and the rest of the nation at roughly the same time. Indiana manufacturing employment began falling sharply in January 2000. The U.S. manufacturing freefall started in July of that year. By December 2001, Indiana had lost 53,200 manufacturing jobs from January 2000 through December 2001 [U.S. Bureau of Labor Statistics]. In just two years, the recession cost the state as many jobs as were lost from 1978 through 1998, a two-decade cycle.³ However, because other sectors of the economy held up well for many months, the severity of the reluctant recession was not diagnosed until late in 2001, by most national economists.

Indiana had lost 53,200 manufacturing jobs from December 1999 through December 2001 ...the recession cost the state as many manufacturing jobs as were lost from 1978 through 1998...



Clearly, the events of September 11, 2001 are playing, and will continue to play, a major role in economic terms. The economic damage for the travel industry alone is staggering, with the air travel and lodging industries having lost 225,000 jobs since this time last year. While not minimizing the magnitude or importance of the events of September 11th, Indiana was in a recession well before the terrorist attacks which have greatly affected our nation.

Indiana's Downward Revenue Spiral:

Identifying turning points in the economy, like recessions, is difficult and hazardous for forecasters. Indiana updates its forecasts annually, but uses monthly forecast targets to monitor trends. The downward spiral in state collections started in the summer of 1999 when monthly revenue collections started falling short of forecast targets.

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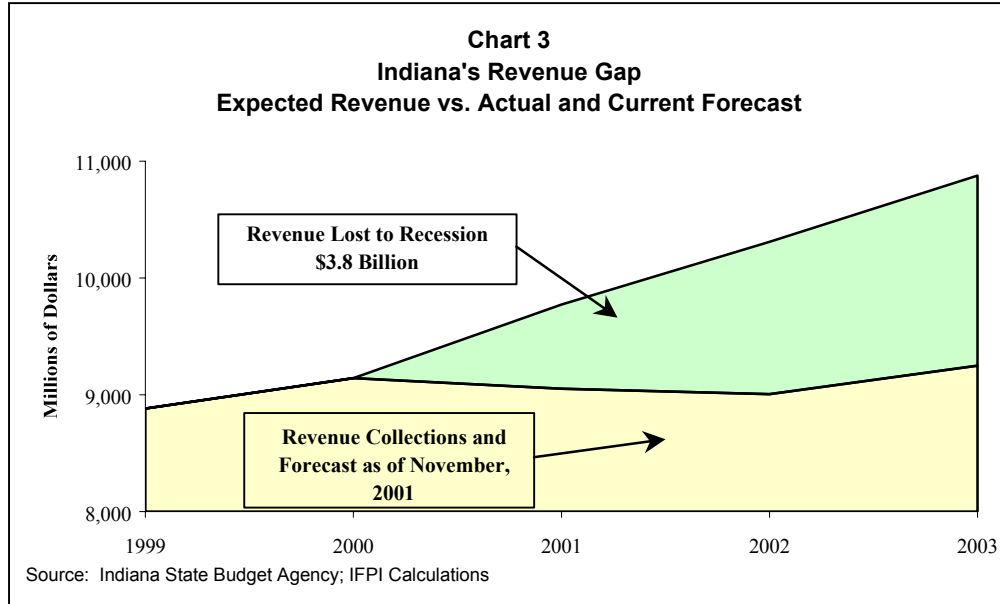
A dramatic indicator that Indiana was in a recession came in the form of declining state revenues. Revenue collections for the state's fiscal year ending June 30, 2001 declined, from the collections for state fiscal year ending June 30, 2000, by 1.0%.

By November of 2000, the state had missed revenue forecast targets for 10 of the previous 12 months. The State's December 2000 forecast, covering fiscal years 2001, 2002, and 2003 lowered revenue projections for the first time in several years by more than \$1.3 billion. Although the December news was grim, the April 2001 forecast update, just 4 months later, lowered projections again, this time by an additional \$900 million.

Table 2.				
Indiana Nominal Revenue Growth				
Current Period and 1990-1991 Recession				
<small>Source: State Budget Agency; IFPI Calculations</small>				
Recession Period	Year 1	Year 2	Year 3	Year 4
1990-1991	<u>1990</u> 4.3%	<u>1991</u> 0.8%	<u>1992</u> 2.2%	<u>1993</u> 5.5%
2001-2002	<u>2000</u> 2.9%	<u>2001</u> -1.0%	<u>2002*</u> -0.5%	<u>2003*</u> 2.7%
<small>*estimates – Nov, 2001 state revenue forecast</small>				

Through the fall of FY 2001, the continued shortfall of state revenues below target and the dismal national economic news had alerted officials to the reality of the fiscal crisis. An early revenue forecast was requested which, when released on November 14th, reduced revenue projections for a third consecutive time. It brought to an astonishing total of \$3.7 billion the amount of expected revenue that has been lost to the current recession. It is now clear that this recession will be more challenging than the last and may approach the severity of the 1981-1983 recession.

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The 2002-2003 budget, which was enacted just 6 months prior to that forecast, was further threatened by this new pessimistic outlook. The biennial budget then stood with a deficit of \$1.0 billion, and all of the state's financial reserves would be exhausted by mid-FY 2003.

Table 3.
Updated Budget Outlook – November, 2001
[millions of dollars]
Source: State Budget Agency; IFPI Calculations

	FY 2002	FY 2003
Revenue	9,289.3	9,508.3
Expenditures	10,137.9	10,488.8
Deficit	(848.6)	(980.5)

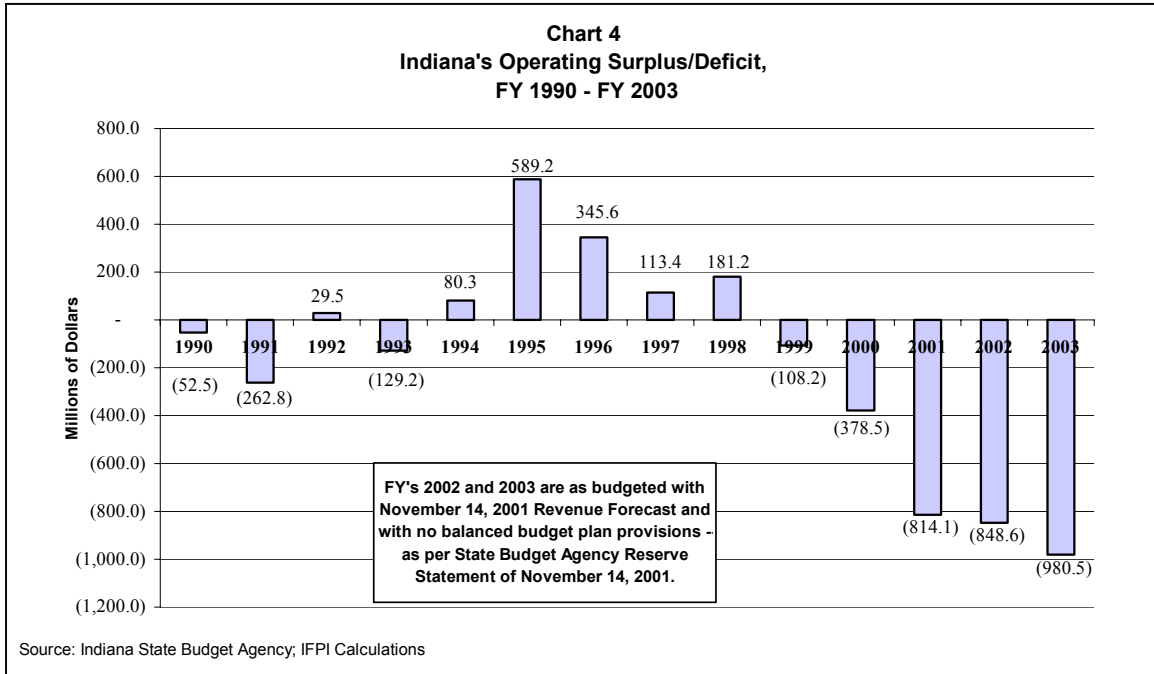
Although it can be easy to develop fiscal tunnel vision, Indiana is clearly not alone in its distress. Survey data from the National Association of State Budget Officers (NASBO) indicated that 38 states, at the end of 2001, were experiencing budget shortfalls for fiscal year 2002 totaling an estimated \$38 billion.⁴ In addition, "State Revenue Report" documents declining state tax revenue (for all 50 states) in the 3rd quarter of calendar 2001 (July – September) for the first time since the last recession. Adjusted for inflation and tax changes, real revenue collections were 5% lower than in the same period in 2000.⁵

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Expenditures and Budget Commitments Continue to Increase:

The fiscal equation for a state, like the family budget, has two sides. Not only revenue or income, but spending, too, plays a part in the bottom line and they are inextricably linked. State spending was severely constrained by the recession in FY 1990-91, growing at 3.5% per year from the recession until FY 1995. At the same time, the recovery resulted in a revenue boom, with revenue growing by heroic annual rates. Although average long-term

revenue growth for Indiana is about 5.4% per year, from 1991 to 1995 state revenues grew by 7.0% annually. The result: by 1995 fiscal year end, the state's combined balances measured 18% of annual revenues and both elected officials and taxpayers started talking about \$2 billion surpluses and questioning whether the state should serve as a bank.



As elected officials recognized that large surpluses were accumulating, expenditure policy became more aggressive. State general fund and property tax replacement fund spending grew at an annual rate of 7.34% from FY 1995 through 2000. The strong spending trend stopped the accumulation of balances, but built an appetite for budget increases that would prove impossible to satisfy.

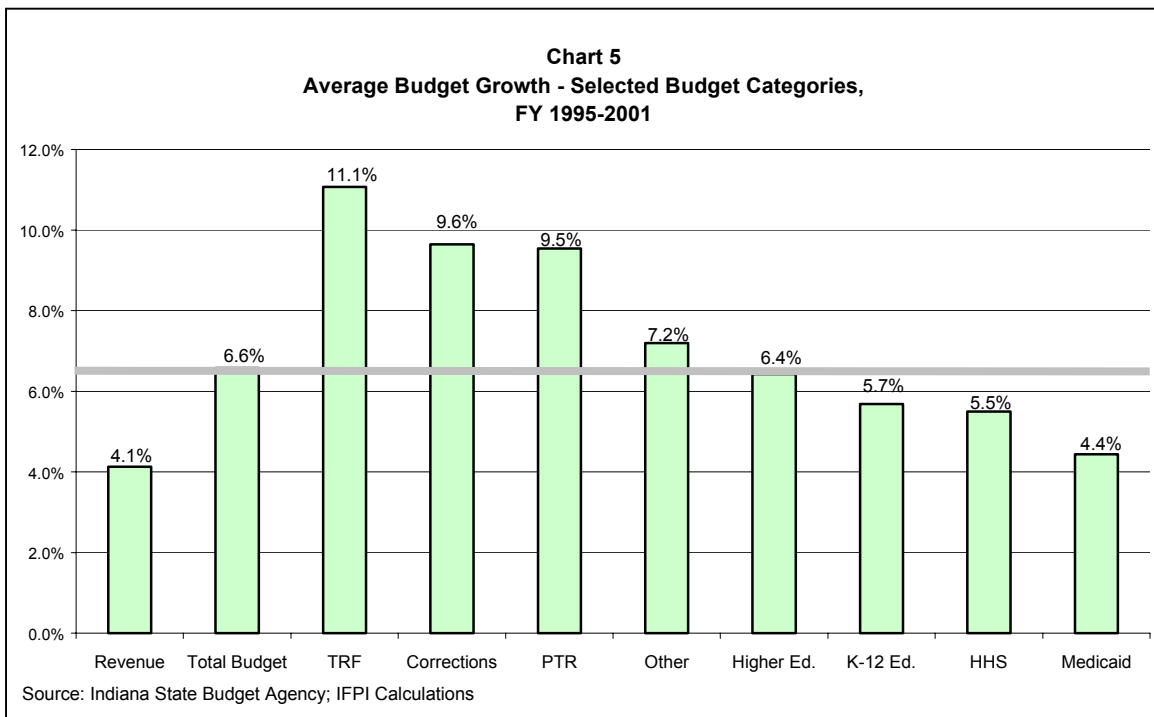
During the period the State was awash in cash, large ticket budget categories – like education and Medicaid – did not keep pace with average spending growth. In fact, in percentage terms, teachers' retirement, corrections, and property tax relief were the priority areas receiving legislators' attention. Although the expressed objectives of many elected officials would indicate a priority on education and health care, these categories have grown at slower rates than the budget as a whole.

Although the expressed objectives of many elected officials would indicate a priority on education and health care, these categories have grown more slowly than the budget as a whole.

The fastest growing category of the budget during FY 1995-2001 was the appropriation to the State Teachers' Retirement Fund (TRF). Following through on a commitment to create a substantial balance in the TRF's Pension Stabilization Fund, the General Assembly went above and beyond their commitment by appropriating an additional \$300 million during the FY 95-97 and the FY 97-99 biennia. These funds serve to reduce future appropriations by accumulating and earning interest prior to the time they are needed to pay benefits to retirees in the 2006 to 2022 timeframe.

Corrections spending is a function of demographic and social trends as well as policy choices by elected officials. The State's General Fund corrections expenditures grew at an annual average rate of 11.1 percent over the FY 1998-2000 period, nearly one and half times the average growth rate for the nation. At least one reason for this spending above the national norm is the lack of alternatives to incarceration being explored in Indiana. Although Indiana has a Community Corrections program and is beginning Workplace and Community Transition programs, the number and extent of the programs continue to be limited.

Indiana's commitment to Elementary and Secondary Education represents more than a third of the state's discretionary spending. Although this category did not grow as rapidly as others during the FY 1995-2001 period, only 5.4% per year, K-12 spending did consume the largest portion of state resources. From FY 1995-2001 state appropriations for K-12 grew by \$967.8 million.



During the early 1990's Medicaid, the state's program of health care for low income individuals was the budget bad-boy. It grew by 11.3% per year from FY 1990 to FY 1994, but slowed to an annual growth rate of only 3.6% in the FY 1995 to FY 2000 period, because of the cuts in benefits and the rapidly improving economy. However, as the national recession has come on the scene, Medicaid costs in Indiana and across the nation have jumped sharply. The Medicaid appropriation for FY 2002 was budgeted at 5%

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over actual FY 2001 expenditures. The FY 2003 appropriation funded a 7% increase over 2002. The Office of Medicaid Policy and Planning (OMPP) stated that the appropriations would be insufficient, based on their forecast of an 11% increase in FY 2002 followed by an 8% increase in FY 2003. In addition, the Court decision in the Day Case (on Medicaid disability eligibility) drove up estimated Medicaid spending, bringing the OMPP's estimate of the appropriation shortfall to approximately \$250 million for the biennium.

Table 4
Growth in Selected Budget Categories – 1995 to 2001
(in millions)
Source: State Budget Agency; IFPI Calculations

Budget Category	FY 1995	FY 2001	Increase
K-12 Education	\$2,571.3	\$3,539.1	\$967.8
Higher Education	\$1,011.3	\$1,469.8	\$458.5
Medicaid	\$881.4	\$1,085.1	\$203.7
Property Tax Relief	\$729.6	\$1,260.8	\$531.2
Corrections	\$327.2	\$568.4	\$241.2
Teacher's Pensions	\$228.2	\$575.9	\$347.7

Finally, a significant part of the reason for budget growth has been expenditures for the creation of new facilities and continued spending on the maintenance of existing capital assets. FY 1996 capital spending increased 68.2% over FY 1995. This increase was to a large extent a catch-up for the lack of investment in state facilities

and infrastructure that had occurred during the early 1990's recession years. By the 2000 and 2001 fiscal years, biennial capital appropriations had grown to \$772.2 million, a 274% increase over the FY 1994 and 1995 biennial expenditure levels.

Not all of the reduction in state balances came as a result of increased spending. The tax cuts enacted in the 1997 and 1999 session permanently removed a significant amount of resources from the state's revenue streams. Income and inheritance tax reductions, while providing voters with a reason to cheer, were not large, overall. However, it was the Governor's election year suspension of the sales tax on gasoline in the summer of 2000, when gas prices were high, that ultimately proved the most popular with the public. Most of these tax adjustments came as the state's revenue collections were showing signs of weakness and budget troubles were appearing on the horizon.

Table 5
State Tax Cuts Enacted Since 1997
Source: State Budget Agency; IFPI Calculations

Tax Cut (millions of \$)	FY 1998	FY 1999	FY 2000	FY 2001
Income Tax	\$ 28.3	\$ 28.6	\$ 86.8	\$ 87.8
Deduction for Dependents				
Income Tax	\$ 14.0	\$ 14.0	\$ 17.4	\$ 17.4
Earned Income Deduction/Credit				
Inheritance Tax		\$ 16.5	\$ 21.4	\$ 21.4
Increased Exemption for Inheritance Tax				
Income Tax			\$ 8.7	\$ 8.9
Deduction for the Elderly				
Income Tax			\$ 10.7	\$ 10.9
Increase Renter's Deduction				
Sales Tax				\$ 46.3
Governor's Suspension of sales tax on gas				
Annual Total State Tax Cuts	\$ 42.3	\$ 59.1	\$145.0	\$192.7
Four Year Total				\$439.1

Property tax relief has likewise been dispensed over the same period to taxpayers in small doses, while the critical problem of the state's reassessment system – the Court-ordered conversion to a constitutionally acceptable assessment standard – has not been addressed. In the past 10 years, direct property tax relief expenditures (which includes the Property Tax Replacement Credit and Homestead Credit) have increased nearly 2 ½ times – from just over \$500 million in FY 1990 to in excess of \$1.2 billion in FY 2001. In effect, during the last four years, the state has increased its commitment to property tax relief by more than ½ billion dollars a year.

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Tax Cut (millions of \$)	FY 1998	FY 1999	FY 2000	FY 2001
Homestead Credit Increase from 4% to 10%	\$49.5	\$102.6	\$110.1	\$118.3
Personal Property Tax Credit (\$12,500 AV)			\$92.4	\$183.8
Property Tax Add-Back⁶ Repeal			\$138.9	\$146.5
County Welfare Levies Eliminate County Welfare & Administration			\$21.8	\$46.4
Property Tax Deduction⁷ Deduction from Individual Income Tax			\$54.2	\$57.3
Annual Total	\$ 49.5	\$102.6	\$417.4	\$552.3
Four Year Total				\$1,121.8

The turning point for the state's fiscal system came in the FY 1999-2001 biennium (Chart 4 above). The budget was built for annual spending growth of 7.3% and 6.2%. Although that spending growth was above average levels, it was intended to spend surpluses down to more normal reserve levels. It turned out to be a major miscalculation. Contrary to policymakers' expectations, revenue growth took a nosedive. With growth rates of 2.9% and -1.0% for fiscal years 2000 and 2001 respectively, the biennial deficit soon totaled \$1.2 billion. Unfortunately, the worst news was yet to come. Absent executive or legislative intervention, the drop in revenues discussed above put the state in jeopardy of running out of funds by the end of FY 2003.

The turning point for the state's fiscal system came in the 1999-2001 biennium. The budget was built for annual spending growth of 7.3% and 6.2%... above average sustainable levels. It turned out to be a major miscalculation.

The reductions in revenue collections and increasing commitments in expenditures bring Indiana to where it is today: the budget is a billion dollars out of balance and the state could very well be broke by sometime in fiscal year 2003.

The O’Bannon – Kernan Balanced Budget Plan:

On November 15, 2001, Governor O’Bannon announced a comprehensive plan to bring the budget back into balance, which included a series of tax increases and expenditure reductions. His plan seeks to preserve the state’s fiscal health through the 2001-2003 biennium and maintain adequate – although certainly more restrained than in previous years – spending growth in the following biennial budget cycle.

Table 7.		
The Balanced Budget Plan – Summary Table		
Source: O’Bannon-Kernon Balanced Budget Plan		
Budget Reduction Plan	FY 2002	FY 2003
Additional Revenue		
Permanent Tax Increases (Legislation needed)	61.3	629.6
Permanent Revenue Reallocations (Legislation needed)	50.0	100.0
Transfer from Rainy Day Fund	165.0	90.0
Total Additional Revenue	276.3	819.6
Expenditure Reductions		
Permanent Base Expenditure Cuts	100.0	303.0
Payment Delays	537.8	-
Reversions (Cap Proj’s Fund – Legislation needed)	176.0	318.2
Total Expenditure Reductions	813.8	621.2
Total Additional Revenue and Expenditure Reductions	1,090.1	1,440.8

The plan relies on tax increases for the major portion of its resource additions. The Governor has asked the Indiana General Assembly to pass a 50 cent increase in the cigarette tax rate which

generates the lion’s share of the added revenue, (\$.155 cents per pack to \$.655 cents per pack). In addition, the Governor would increase the riverboat admissions tax and reallocate \$150 million from gaming proceeds and tobacco settlement funds. Finally, \$250 million is transferred from the Rainy Day Fund, bringing it’s balance by the end of the biennium down to \$307.3 million.

Unfortunately, propping-up state resources during a fiscal crisis through tax increases is not popular with taxpayers. While raising “sin taxes” [gaming and tobacco] are old standbys as fiscal policy options in hard times, the revenue increase side of the Governor’s plan may find rough sledding. Few elected officials want to raise any taxes any time, let alone when taxpayers and the overall economy are suffering. The reality, however, is that they generally do. In the 1990-91 recession, 45 states raised one or more of their taxes.

Table 8.				
The Balanced Budget Plan				
Source: O’Bannon-Kernon Balanced Budget Plan				
Tax Increases; Tax Cut Repeals	FY’02	FY’03	FY’04	FY’05
Cigarette Tax - 50 cent increase	61.3	367.9	370.2	373.1
Riverboat Admissions Tax - \$2 increase		84.0	84.0	84.0
Fee Increases		15.0	15.0	15.0
Repeal Income Tax Deduction for Property Tax and Business "add-back"		162.7	171.5	178.4
Total Permanent Tax Increases	61.3	629.6	640.7	650.5

Few policy makers want to raise taxes at any time, let alone when taxpayers and the overall economy are suffering.

Survey data from the National Association of State Budget Officers [NASBO] in December of 2001 indicated that 38 states have declared themselves to be in a “budget shortfall” with a mix of policy responses being contemplated. Of the 38 states responding, 12 give no indication as to what they intend to do in response to their fiscal crisis. Of the remaining 26, 22 states declare that they will respond only with budget or spending cuts. There are 4 that mention the possibility of raising taxes. It is likely, however, that as time passes the number of states considering some form of tax increase will grow.

The Governor’s Plan on the spending side makes a number of cuts, but also relies heavily on the policies the Indiana General Assembly enacted through its passage of the 2001-03 biennial budget. In FY 2002, the plan cuts \$813.8 million in fiscal year spending – of which two-thirds or \$537.8 million consists of delayed expenditures for public schools, property tax relief, and higher education passed as part of the budget bill in the FY 2001 legislative session.

The Governor’s Plan...also relies heavily on the work of the Indiana General Assembly through its passage of the 2001-2003 biennial budget.

Table 9.				
Governor’s Balanced Budget Reduction Plan				
<small>Source: O’Bannon-Kernon Balanced Budget Plan</small>				
Proposed Expenditure Reductions	FY 2002	FY 2003	FY 2004	FY 2005
Permanent Base Expenditure Cuts				
Medicaid	100.0	150.0	157.5	165.4
State Agency Budgets		109.0	114.5	120.2
Higher Education Operating Appropriations		29.0	30.5	32.0
TRF COLA Appropriation		<u>15.0</u>	<u>15.8</u>	<u>16.5</u>
Total Permanent Base Expenditure Cuts	100.0	303.0	318.2	334.1
Payment Delays				
Higher Education	94.4			
K-12 Education	289.3			
Property Tax Replacement & Homestead Credit	<u>154.1</u>			
Total Payment Delays	537.8			
Reversions				
From operating budgets – all agencies except ed	113.0	203.0	53.0	25.0
No pay raises for state employees	15.0			
State agency capital and R&R	32.0			
K-12 Tuition Support Appropriation		115.2		
Higher Education R&R	<u>16.0</u>			
Total Reversions	176.0	318.2	53.0	25.0
Total Expenditure Reductions	813.8	621.2	371.2	359.1

Based on the Office of Medicaid Policy and Planning December 2001 estimates, Medicaid expenditures would exceed the appropriation for FY 2002 by \$83 million and for FY 2003 by \$168 million. The Day Case alone adds \$64 million to the biennial estimate, and those numbers do not include OMPP’s estimate of as much as \$322 million in retroactive liability. The Governor has pledged to keep Medicaid expenditures within budget appropriations, which means cutting outlays by \$100 million in FY 2002 and \$150 million in FY 2003.

Table 10.
Medicaid Appropriation, Forecast, and Shortfall Estimate
Source: Office of Medicaid Policy and Planning, December 2001; IFPI calculations

December Forecast	FY'01	% Inc	FY'02	% Inc	FY'03	Total
Base Appropriation	1,018.9	11.1%	1,131.9	6.9%	1,209.6	
Shortfall Actual/Estimate	58.5		64.2		123.1	187.3
Impact of the Day Case	—		18.7		45.2	63.9
Total Expenditure Estimate	1,077.4	12.8%	1,214.8	13.4%	1,377.9	1
Governor's Announced Savings			82.9		168.3	251.2

In addition to the Medicaid cuts, the plan proposes \$153 million in permanent spending cuts coming primarily from state agencies but also affecting university budgets. More traditional cost cutting is addressed in the plan through trimming agency operations, state personnel expenditures, and deferred capital. The plan also asks local schools to fund the State increase from FY 2002 to FY 2003 in tuition support payments through a re-allocation of \$115.2 million in local capital projects' fund dollars – shifted to their operating budgets. These changes would boost the reversions from appropriations in the state's budget from a \$50 million per year total to \$379 million, a savings of \$279 million.

Budget cuts of the magnitude included in the Governor's plan will offset some of the generalized growth in the functions of government over the past 6 years. The plan requires the state to closely examine its recent spending habits and, if successfully implemented, will reduce the state's base budget by perhaps as much as \$500 million from the level enacted last April.

The Plan requires the state to closely examine its recent spending habits and, if implemented, will reduce the state's base budget by perhaps as much as \$500 million from the level enacted last April.

Possible Critiques of the Plan:

The reallocation of funds from lottery and gaming revenue and from the tobacco settlement proceeds reduces earmarked funding for several highly popular and visible programs. Alternate dedicated sources for lottery and gaming funded programs have not been identified and some of those programs may face reduction or elimination. A portion of the tobacco

Table 11.
The Balanced Budget Plan - Programs at Risk from Reallocation of Funding
Source: O'Bannon-Kernon Balanced Budget Plan

Revenue Source	Programs Funded
Lottery and Gaming Revenue - \$100 million per year starting in FY 2004 - \$10 million per year currently earmarked for Horse Racing starting in FY 2003	K-12 & Higher Education Technology 21 st Century Research & Technology Fund Local Infrastructure (Build Indiana Fund Grants)
Tobacco Settlement Funds - \$50 million in FY 2002 - \$90 per year thereafter	Tobacco Cessation Regional Health Care Construction Prescription Drugs for Seniors

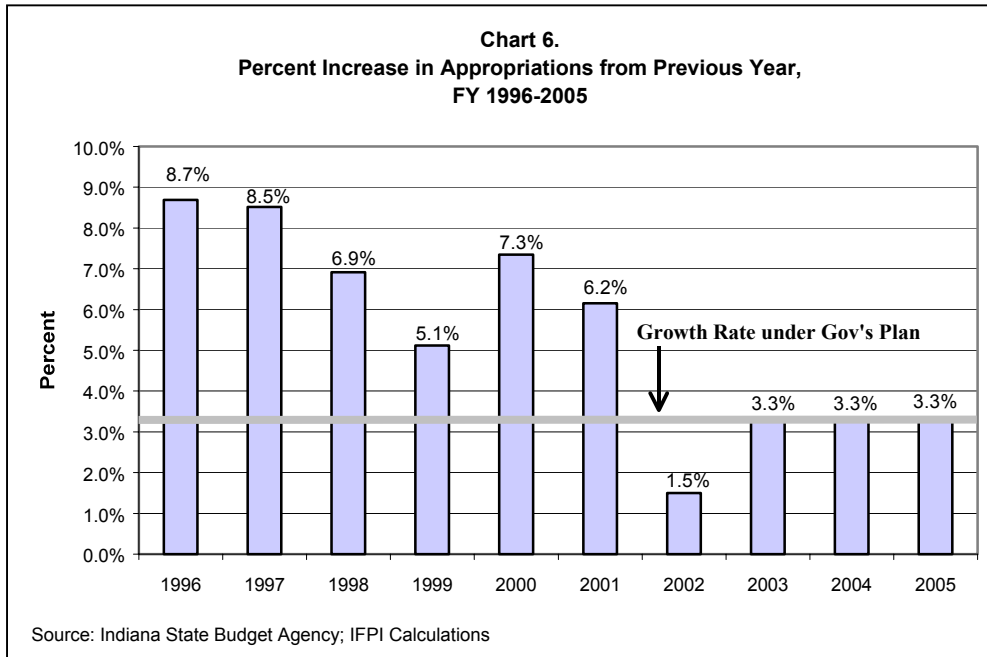
settlement reallocation is to come from money currently dedicated to the tobacco settlement trust fund, but some reallocation from other existing programs may be necessary.

The impact of the national recession on Indiana, its depth and extent, are far from certain. Although some forecasters suggest that it will be short and mild, there is a significant risk it will last longer than expected and worsen an already bleak state revenue situation. If that happens, both the revenue additions and budget cuts in the Governor's Plan will fall short of maintaining the state's fiscal structure.

Another risk to the longer-term success of the Governor's Plan is the challenge of finding as much as \$500 million of expenditures to cut. After the restrictions and reductions have been put in place in FY 2003, the proposed balanced budget for FY 2004 and 2005 requires total state GF appropriations growth to be limited to 3.3% per year.⁸ The state can expect extraordinary pressures to restore and increase spending for many of the programs affected by the budget cuts necessitated by the recession, once it has past.

...maintaining spending growth rates at ½ the level of the last 6 – 8 years will require considerable effort and discipline by both the Governor and General Assembly.

Without a doubt, maintaining spending growth at rates ½ the level of the last 6 – 8 years will require considerable effort and discipline by both the Governor and the General Assembly.



Finally, if completely implemented, the plan leaves estimated combined balances of approximately \$800 million at the end of FY 2002 and nearly \$1.0 billion at the end of FY 2003. The state has the \$537.8 million liability from the payment delays that, if repaid, would reduce balances, but the plan doesn't call for them to be repaid until at least fiscal year 2005, and then only in part. For purposes of these budget balance models, the payment delays are not shown. The delays are not legal liabilities to which the state is committed and therefore, while there is an expressed desire to repay them, they do not in fact reduce the state's balances until such time at the state actually repays them. The Medicaid reserve is

Table 12.				
Governor's Balanced Budget Plan (BBP)				
Source: O'Bannon-Kernon Balanced Budget Plan				
	FY 2002	FY 2003	FY 2004	FY 2005
Beginning Balance	18.6	51.8	318.7	312.0
Forecast Revenue	9,005.5	9,249.5	9,735.1	10,246.2
BBP Increases	61.3	639.6	650.7	660.5
Other Revenue	107.5	247.5	247.5	247.5
Transfer of Balances	<u>365.0</u>	<u>165.0</u>	—	—
Total Revenue	9,539.3	10,301.6	10,633.3	11,154.2
Budget Act Approp. (04,05 est.)	10,211.9	10,497.9	10,845.8	11,207.6
Judgments and Settlements	8.0	8.0	8.0	8.0
Medicaid Shortfall	100.0	150.0	157.5	165.4
Adjusted Net Estimated Approp.	10,319.9	10,655.9	11,011.3	11,381.0
Reversions	(176.0)	(203.0)	(53.0)	(25.0)
Payment Delay/Repay	(537.8)			269.0
BBP Reductions		(268.2)	(160.8)	(168.7)
Medicaid	<u>(100.0)</u>	<u>(150.0)</u>	<u>(157.5)</u>	<u>(165.4)</u>
Total Expenditures	9,506.1	10,034.7	10,640.0	11,290.9
Operating Surplus/(Deficit)	33.2	266.9	(6.7)	(136.7)
Ending Balance	51.8	318.7	312.0	175.3
Medicaid Reserve	100.0	100.0	100.0	100.0
Tuition Reserve	265.0	265.0	265.0	265.0
Rainy Day Fund	382.0	307.3	319.6	332.4
Total Balance	798.8	991.0	996.6	872.7

intact at \$100 million, the Tuition Reserve remains untouched at \$265 million, and the Rainy Day Fund, statutorily created for exactly the fiscal stress the state now faces, retains over \$300 million at the end (projected) of the biennium.

Table 12 illustrates the effect of the Governor's Balanced Budget Plan on the state's combined balances. Those balances remain at or above \$800 million and grow, by FY 2004, to over \$1.0 billion, allowing the beginning of repayment of the delayed distributions. With these projected balances, the plan may be "too good." If these healthy balances are seen as too high, the General Assembly may decide that other elements of the plan will not be necessary.

The NO-Tax Alternative

Some policymakers in Indiana will certainly say that the correct option for managing through a fiscal crisis is to avoid any tax increase at all. Some states have already made a "no tax increase" pledge as they begin to deal with the results of the current recession. Although we can only speculate, it is instructive to attempt to model a recovery plan for Indiana that relies completely on budgetary cuts and re-allocations of balances. Like any simulation, this exercise is intended to give approximate results from which we can learn the general direction and magnitude of the impacts of the decisions policymakers might make.

Table 13 contains a projected state balance sheet with forecast revenue through FY 2003 and revenue growing at 5.25% thereafter, (the same revenue growth assumptions contained in the Governor's plan), without the tax increases. The specific budget cuts outlined in the Governor's plan are also assumed. No additional changes are implemented through the end

of the FY 2002 and FY 2003 biennium. It is instructive to observe that the balance at the end of FY 2002 is very close to that of the Governor's Plan with the only difference the \$61.3 million in projected cigarette tax receipts for that year. By the end of FY 2003 the differences between the No-Tax Plan and the Governor's Plan are more startling. If only the cuts contained in the Governor's Plan are implemented, state spending grows by another roughly \$500 million and the mismatch between current year revenues and current year spending (the Operating Deficit) grows to minus \$372.7 million. The state's total balances at FY 2003 end would be \$290.1 million.

Fiscal Year	FY 2002	FY 2003	FY 2004	FY 2005
Beginning Balance	18.6	(9.5)	(382.2)	(379.6)
Forecast Revenue	9,005.5	9,249.5	9,735.1	10,246.2
Other Revenue	107.5	247.5	247.5	247.5
Transfer of Balances	<u>365.0</u>	<u>165.0</u>	—	—
Total Revenue	9,478.0	9,662.0	9,982.6	10,493.7
Budget Act Approp. (04,05 est.)	10,211.9	10,497.9	10,845.8	11,207.6
Judgments and Settlements	8.0	8.0	8.0	8.0
Medicaid Shortfall	100.0	150.0	157.5	165.4
Adjusted Net Estimated Approp.	10,319.9	10,655.9	11,011.3	11,381.0
Reversions	(176.0)	(203.0)	(53.0)	(25.0)
Payment Delay/Repay	(537.8)	—	—	269.0
BBP Reductions	—	(268.2)	(160.8)	(168.7)
Medicaid	(100.0)	(150.0)	(157.5)	(165.4)
Additional Reduction Needed	—	—	<u>(660.0)</u>	<u>(800.0)</u>
Total Expenditures	9,506.1	10,034.7	9,980.0	10,490.9
Operating Surplus/(Deficit)	(28.1)	(372.7)	2.6	2.8
Ending Balance	(9.5)	(382.2)	(379.6)	(376.8)
Medicaid Reserve	100.0	100.0	100.0	100.0
Tuition Reserve	265.0	265.0	265.0	265.0
Rainy Day Fund	382.0	307.3	319.6	332.4
Total Balance	737.5	290.1	305.0	320.6

In order for the state to continue operations into FY 2004 and beyond, additional spending cuts of \$660 million in FY 2004 and \$800 million in FY 2005 would need to be found. These cuts could be made from many areas of the budget, but it would be virtually impossible to avoid major cuts in significant budget categories like K-12 education, higher education, Medicaid and property tax relief.

To maintain combined balances in the FY 2004 – 2005 biennium at about \$300 million (or 3% of operating revenue, about the minimum needed to meet normal cash flow needs), spending would again have to remain flat in FY 2004. In Table 13 one-half of the payment delay is repaid in FY 2005, as was assumed under the Governor's Balanced Budget Plan. Under this "no-tax plan" Total Expenditures (net of additional reductions) grows by 5% in FY 2005 with the payment delay repayment, but if that is factored out (it is not new spending) then net expenditures grows by only .9% per year for the entire FY 2004 and FY

2005 biennium. It not until FY 2006 that, assuming normal revenue growth, would anything approaching “normal” spending increases be possible. These results are all based on the assumptions behind the balanced budget plan, including the state’s official revenue forecast, which does not estimate the state’s revenue beyond FY 2003, at this time. The first forecast for FY 2004 – 2005 will not occur until December of 2002.

Another possibility for the state to avoid a tax increase exists. If revenue growth exceeds the average rates contained in the Governor’s Balanced Budget Plan, then the need to raise taxes or find major spending cuts would be obviated. However, the magnitude of those revenue increases would have to be astounding. If the current revenue forecast – through FY 2003 – proves accurate, then revenue in the next biennium would need to grow by 12.5% in the first year and 6.5% in the second year in order to maintain appropriations growth at the 3.3% per year projections contained in the Governor’s Balanced Budget Plan proposal.

Findings and 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 or allocated to “unnecessaries” 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.”⁹** 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 certainly not clear that the tax cuts enacted from FY 1995 through FY 1999 were based on thoughtful policy direction. The attempt to lower property taxes, 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 clearly have an 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. *We recommend that the State Budget Agency 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 depends 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 only 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."*¹⁰ 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.*

A Final Thought

This report has demonstrated that Indiana's budget position is serious; this is not a video game. Short-sighted, short term actions now, can do long-term damage to Indiana's economic and fiscal health. A thoughtful, bipartisan approach to increasing resources without exacerbating the plight of taxpayers caught in an economic downturn is a critical part of managing through this state fiscal problem. By the same token, a bipartisan willingness to explore every possible means of cutting spending short of damaging the state's infrastructure, diluting the education of its children or impairing the productivity of its workforce needs to be found. If our elected officials can find a balanced solution that includes utilization of both additional resources and reduced spending, the state will have taken the first steps toward an optimal path of recovery.

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.

³ "Transforming the Economy Study of Northwest Indiana," A joint research project of the Indiana University Business Research Center and the Indiana Fiscal Policy Institute. December, 2000.

⁴ "State Budget Update," National Association of State Budget Officers, October 31, 2001.

⁵ "Severe Decline in State Tax Revenue," Nicholas W. Jenny. December, 2001, The Nelson A. Rockefeller Institute of Government.

⁶ Eliminating the property tax add-back serves to lower the after-tax cost of property tax payments.

⁷ The property tax deduction reduces the after-tax cost of property tax payments.

⁸ State budget Agency 4 year surplus statement, November 15, 2001

⁹ John Stuart Hall, Arizona Policy Choices, School of Public Affairs, Arizona State University, 1999.

¹⁰ "The 1993-1995 Indiana State Budget," Indiana Fiscal Policy Institute, April 1993.