INDIANA FISCAL POLICY INSTITUTE
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2021 in Review – Highlights from the Indiana Fiscal Policy Institute

2022 marks the Indiana Fiscal Policy Institute's 35th year serving Indiana and its taxpayers with impartial, impactful analysis of state and local tax and budget issues. The New Year also begins a new session of the General Assembly that looks to feature significant debate on fiscal matters – more than the typical non-budget year – as the state continues its economic and revenue recovery from the short-term COVID downturn.

But before turning the page, it's worth looking back at 2021, which started with cautious optimism about the FY2022-2023 budget cycle that grew into a blockbuster $37.4 billion spending plan supported by surging revenues and federal aid through the American Rescue Plan Act. As they prepare to reconvene, lawmakers are still processing a new forecast that adds another $3.3 billion to anticipated two-year tax collections.

The next few pages recall five key storylines from 2021. While it's become cliché to cite "these unprecedented times," these are a few unique circumstances from the last twelve months that continue to frame policy discussions heading into the next twelve (and highlighting some of IFPI's work along the way).

IFPI's Fiscal Top Five: 2021 in Review

The COVID Crisis (continued):

COVID once again cast a long shadow over our state and nation in 2021. But the year began with a new phase in the battle against the virus, beginning the deployment of COVID vaccines to healthcare workers, the most vulnerable Hoosiers and then the public-at-large along with county-by-county easing of remaining restrictions.

Sadly, progress against the pandemic has been stalled by lagging vaccination rates, while the emergence of new variants poses a renewed threat to continued economic recovery and healthcare capacity.

While the human cost of the pandemic have been staggering, the short-term fiscal effects of COVID were more modest than anticipated. However, the chances of long-term trauma to Indiana's economy and tax base grow if a resurgent virus continues to ravage workplaces, depress productivity and rattle consumer confidence.

In March, IFPI released an issue brief on the performance of local food and beverage taxes during 2020. The analysis showed the dramatic impact of COVID restrictions on the restaurant and hospitality industry (and highlighted the volatility of local revenue streams dedicated to tourism and redevelopment projects as well).

The more interesting insight from the data is how consumer activity (as measured by tax collections) slowed with rising case counts, ahead of changes to capacity limits. Without trying to read too much into one narrow barometer of retail activity, it does reinforce a broader point: A strong post-pandemic economy depends on how well we manage the virus, not how quickly policymakers end public health precautions.

The American Rescue Plan Act:

2021 also brought a new administration with a more expansive vision for the federal response to the COVID, an approach that would reshuffle Indiana's budget calculus in the spring. The American Rescue Plan Act (ARPA) included $360 billion in flexible state and local aid; President Biden's signing of the plan in March sent more than $7.5 billion of this sum to Indiana, divided among state government, school districts, cities and counties.

Non-school local funding includes roughly $2.6 billion allocated to each of our 92 counties (by population), twenty-five 'metropolitan' cities (populations over 50,000) and hundreds of smaller municipalities. These funds can be used through 2026 for COVID-related recovery programs, health and safety initiatives, emergency pay for front-line public employees, water system upgrades and filling in budget gaps created by the pandemic. (IFPI is working with local partners to track how local governments are putting this influx of resources to work.)

Indiana's state-level share of ARPA totaled more than $3 billion, dropped into the midst of Senate budget deliberations. As some lawmakers voiced displeasure over the lack of executive branch consultation on CARES Act spending, the General Assembly seized the initiative by integrating ARPA funds into a new iteration of the state's two-year spending plan. The chart below shows the major uses of federal aid in the final budget.

Regional Economic Acceleration & Development Initiative	$500M
Next Level Connections – Infrastructure	$1.1B
Water/Transportation Infrastructure Grants (IFA)	$160M
Broadband Development Grant Program	*$250M*
Career Accelerator Initiative	$75M
Small Business Recovery Grant Program (HB1004)	$60M
Trail Development/Land Conservation	$85M
Northwest RDA/Intermodal Study	$232M
Mental Health Grant Program	$100M
Public Health Challenge Grant Program (HB1007)	$50M
State/Local Law Enforcement – Body Cameras (HB1006)	$30M
Unemployment Insurance Fund	$500M

First on the list to the left is one of the highest-profile uses of Indiana's ARPA allocation, the Regional Economic Acceleration and Development Initiative. READI is a $500 million grant program encouraging regional strategies focused primarily on talent attraction.

The first READI awards were recently announced, based on regional development plans spanning nearly every county and community across the state.

In May, **IFPI hosted a virtual panel discussion** featuring national, state and regional experts and officials putting this important initiative in context.

Senator Travis Holdman, who urged the Indiana Economic Development Corporation (IEDC) to "think bigger" in budget hearings, discussed the opportunity to scale up investments in human capital and regional competitiveness.

From the state-level view to front-line insights from local and regional leaders, Fishers Mayor Scott Fadness and the Northwest Indiana Forum's Heather Ennis discussed plans to leverage new resources like READI to enhance their communities' appeal to people and employers.

Mark Muro of the Brookings Institution also joined the discussion, and later wrote, "Indiana's READI program impressively takes advantage of the opportunity the American Rescue Plan has given to states and cities…Indiana has gone big on one of the toughest challenges states face and raised hopes for the next decade." Governor Holcomb has already signaled his intention to seek second-round funding for the program in 2023, setting up the need to replace federal aid with sustainable state resources to continue READI.

Passing the 2022-2023 Budget:

READI was just one piece of a two-year, $37.4 billion state budget plan that featured major investments in economic recovery, infrastructure and public health priorities backed by federal dollars, with most agency budgets restored or increased after the COVID-imposed cutbacks of 2020. A favorable December revenue forecast framed the start of the 2022 legislative session, and tax collections from January through March were exceeding estimates by more than $400 million when details of the ARPA package hit the Statehouse.

But the dominant headline of the finished product was K-12 education, after the mid-April forecast update added nearly $2 billion to December's projections for FY2022 and 2023. The unexpectedly bright forecast allowed budget conferees to add another billion dollars to local school funding above the (pre-forecast) final Senate version in the waning days of the session.

This meant a $18.7 billion total investment in K-12 education for the biennium, a $1.9 billion increase over the previous budget. By adding $620 million in tuition support in the final deal, the finished budget boosted direct per-student aid by $1.03 billion total in FY2022 and 2023 (over FY2021), also allowing Governor Holcomb and legislative leaders to claim victory on the $600 million annual operating gap identified by the Next Level Teacher Pay Commission. The budget also directs school districts to dedicate at least 45% of tuition support to teacher salaries, addressing compensation without inserting the legislature further into district-level negotiations.

For more on K-12 and regionalism as the big winners of the budget, check out this piece from late April.

The current budget is the product of a strong economic recovery from the depths of the pandemic, bolstered by direct ARPA aid but also built on a foundation of solid pre-COVID fiscal management. Budget plans changed significantly as the fiscal climate continued to improve; given the unprecedented set of circumstances, the rapid evolution of the state's revenue projections is a story in itself.

The Evolution of Indiana's Revenues & Reserves:

In December of 2020, with monthly revenues continuing to edge above estimates (but the future of federal aid, the vaccine rollout and consumer confidence uncertain at the time) the State Budget Committee received a revenue forecast predicting FY2021 revenues at $17.7 billion (3.5% "real" growth over FY2020 after adjusting for delayed income tax payments) and modest growth for FY2022-2023 ($34.95 billion).

After a year of COVID turmoil and fiscal uncertainty, this projection was greeting by sighs of relief…yet it would prove to be the floor for fiscal expectations in the year to come.

The revenue outlook continued to improve: Unemployment kept falling (with higher-paying jobs recovering at a faster pace, buoying income tax collections), consumer spending on goods kept growing at a brisk pace (stimulated further with the passage of ARPA) and economic confidence rising in tandem with vaccination rates.

As noted above, the April forecast update added $2 billion to the biennial bottom line, driving final budget negotiations. And even this would prove to be a conservative take on the state's surging revenues.

Collections from April through June would ultimately outgrow monthly estimates by another billion dollars, pushing the budget surplus to $3.9 billion for the FY2021 close-out and triggering the state's automatic tax refund law. (**IFPI released a brief on the FY2021 close-out** that summarized Indiana's enviable fiscal position kicking off the new fiscal year on July 1.)

Tax cuts were a hot topic during IFPI's Legislative Panel in October, with Senator Ryan Mishler (screen), (seated, L to R) Representative Gregory Porter, Senator Fady Qaddoura and House Ways & Means Chair Tim Brown.

Looking ahead to 2022: The size of the surplus and strength of predicted revenue growth through FY2023 intensified discussions about permanent tax relief during the next session of the Indiana General Assembly. House GOP leadership has been most outspoken about returning money to Hoosier taxpayers: Speaker Huston said of the expansive surplus, "My biggest fear is if we keep it, we'll spend it." Ways & Means Chairman Tim Brown also expressed support for tax reforms in comments at IFPI's Annual Meeting in late October.

Governor Holcomb and Senate Republican leaders adopted a wait-and-see attitude ahead of the December 16th release of a new revenue forecast, which did nothing to quell speculation that Indiana could join the eighteen states that already acted on tax cuts in 2021. **(IFPI looked at the competitive landscape on tax reform heading into the State Budget Committee forecast announcement).**

Indeed, the **latest forecast** delivers another dose of stunning news about the trajectory of Indiana's revenue rebound: It adds $3.3 billion to earlier two-year projections, pushing the state surplus over $5 billion this year and $4 billion by the end of Fiscal Year 2023, even after subtracting $540 million in automatic income tax refunds, more than $3 billion to shore up public pension funds (actual and anticipated) and $500 million in university construction projects.

Putting the forecast in perspective: With another set of eye-popping revenue estimates, it's important to add some background perspective for those questioning whether the numbers could be too good to be true.

Adjusting for delayed income tax payments in 2020, annual revenue growth from FY2019 (pre-pandemic) through FY2021 was 6.5%. That's just one percent higher than the 5.4% increase from FY2018 to 2019; the legislature acted that year to boost future revenues by authorizing online gambling and applying sales taxes to e-commerce facilitators like Amazon.

Net earnings in Indiana have recovered at a faster pace than the rest of the nation (likely due to the strength of Hoosier manufacturing as durable goods consumption grew through COVID). The unprecedented infusion of federal stimulus drove consumer spending, spiking sales tax revenue, and Indiana's decision to tax enhanced unemployment benefits further bolstered income tax collections.

The new forecast continues a similar year-over-year growth trend through FY2022 (nearly 8%), decelerating to 1.7% in FY2023 after the state's job market fully recovers from COVID, spending on (non-taxable) services resumes pre-pandemic growth at the expense of goods and federal aid filters out of the economy.

This averages out to 4.7% annual growth in FY2022 and FY2023. Again, an impressive rate that's also not wildly divergent from longer-term trends of the sales and income tax base: From 2002 through 2018, Indiana consumer spending on durable goods grew at an annual pace of 4%. Removing the Great Recession years (2008-2009), state taxable income increased more than 3% per year over the same period.

Indiana's revenue performance is incredible, but not inexplicable given the circumstances. With the surplus remaining well above 20% of planned expenditures but growth beginning to slow in FY2023, there's plenty of ammunition for debate on the right balance between tax cuts and cautiously guarding a larger reserve into the next biennium. (At least one bill, HB1027, has been filed to reduce the state income tax rate from 3.23% to 3%.)

What about the Local Budget Outlook?

Indiana's revenues are surging at the state level, but local governments – while enjoying largely stable finances and the flexibility to apply ARPA funding to certain priorities – face a more constrained budget climate in 2021 and looking into the New Year.

Much of IFPI's recent research has focused on the complexities of funding local government – supporting police and fire protection, street repairs and stormwater systems, all the essential services and amenities delivered by counties, municipalities and other taxing units like townships. Our 2020 analysis of **local revenue capacity and service costs** by Purdue economist (and leading expert on Indiana tax and budget matters) Larry DeBoer details the challenges facing urban, rural, suburban and industrial communities.

State policies have gradually limited the property tax base since the mid-1970s, narrowing the largest and most predictable source of local revenues. To compensate, local income taxes (LIT) have been expanded, a trend accelerated by efforts to ease the court-ordered shift to market rate property assessments in the early 2000s: In 2000, non-school local units of government raised less than $2 of income tax revenue for every $10 of property taxes. By 2020, that ratio had grown to nearly $8 in LIT per $10 in property tax collections.

This year, we turned again to Professor DeBoer to look into the details of the LIT system and opportunities to ease local budget pressures going forward.

His report, **"Indiana's Local Income Tax: Distributions and Balances in Recession and Expansion,"** is available at www.IndianaFiscal.org. It begins with some background on LIT, getting to the crucial administrative issue: State and local income taxes are collected together by the Indiana Department of Revenue, a convenience for taxpayers that creates a more complex revenue system for counties.

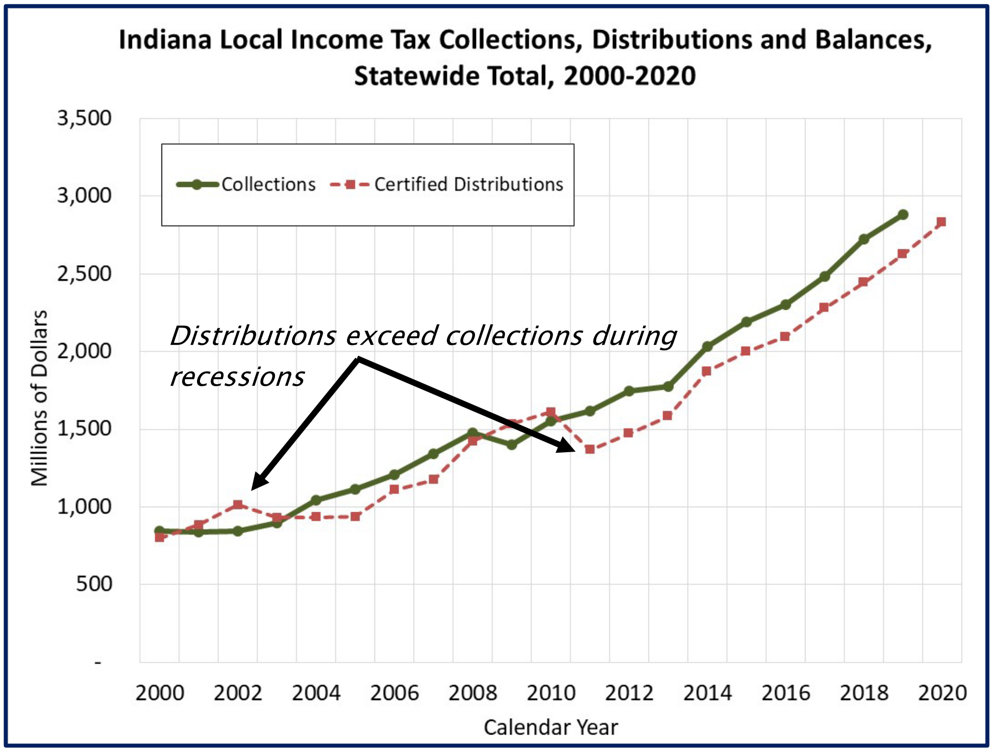
The state's share of income tax payments go directly into the general fund to support the current budget based on revenue forecasts; local revenues, on the other hand, are deposited into county LIT accounts and distributed based on past collections. Specifically, distributions are based on tax returns processed from the previous state fiscal year, creating an effective two-year gap between income being earned, taxes filed and distributions made. (2022 LIT estimates, for example, are based in part on earnings from 2020.)

When taxable income grows, collections are higher than distributions during this two-year delay and balances build up in these accounts. These balances protect against recessions, when incomes decline and collections fall below distributions that were calculated based on a healthier economy. Managing these balances has been a recurring challenge in the system.

Balances were too low going into the Great Recession, and 59 counties ended 2010 with deficits in their LIT accounts – causing the General Assembly to require a minimum balance of 15% of annual distributions in each account to further insulate the system against downturns. But In 2020, balances hit a billion dollars across all 92 counties, or more than 30% of annual distributions.

Professor DeBoer finds that the system will invariably push balances beyond the 15% statutory limit during long economic expansions as collections consistently outpace distributions. Supplemental distributions are meant to manage excess balances, but are also based on delayed data (prior year account balance reports) so combined distributions can never 'catch up' to actual collections. Interest income also adds to year-end balances without being factored into distributions.

Dr. DeBoer looked at how the COVID downturn affected LIT collections and balances, and stress-tested the system against more severe recession scenarios as well. His analysis suggests state balance requirements could be reduced from 15% to 11-12% to release more than $200 million to local governments and narrow the gap between collections and distributions going forward. We're hopeful that this study finds a receptive audience in the General Assembly as part of the broader tax reform discussion in 2022.



Indiana's LIT System:

The chart to the left, from Professor DeBoer's analysis of twenty years of local income tax (LIT) data, shows the challenge of managing the delays between collections and distributions during recession (when declining income risks shortfalls in county LIT accounts) and expansions (when balances grow in accounts).

By adjusting the state-mandated 15% balance requirement, we can release excess reserves and narrow the gap between future collections and distributions, strengthening local budgets as LIT contributes a growing share of revenue capacity.

A final note as IFPI begins its 35th year:

As a privately-supported public asset, the Indiana Fiscal Policy Institute relies on its members to pursue independent research and reporting on Indiana's finances, studying the often-complex issues – from school funding formulas to local property tax controls – that affect the daily lives of Hoosiers in both obvious and unrecognized ways. We'd be remiss to close this review of 2021 without thanking all of IFPI's members and partners, and recognizing our outgoing and current volunteer leadership:

Gretchen Gutman (Cook Group) – chair of IFPI's Board of Directors for 2020 and 2021

Andrew Miller (Bose Public Affairs) – vice-chair (2021), elected chair of the IFPI Board of Directors for 2022

Brian Davey (Duke Energy) – 2021 Board secretary, current (2022) vice-chair

Brian Tabor (Indiana Hospital Association) – treasurer (2021-present)

Jeff Rea (South Bend Regional Chamber of Commerce) – current (2022) secretary of the IFPI Board of Directors

Katrina Hall (Indiana Farm Bureau) – previous Board chair (2018-2019) and Executive Committee member