INDIANA FISCAL POLICY INSTITUTE
SINCE 1987

Revenue Capacity-Service Cost Index of Indiana Local Government:

Where local budget pressure was building before the COVID recession, 2002-2018

Before the COVID recession sparked sharp declines in state revenue collections, local governments serving the communities where most Hoosiers live and work were already grappling with fiscal stress during a decade of recovery.

The latest study from the Indiana Fiscal Policy Institute, **"Capacity-Cost Indexes for Indiana Local Governments – 2002 & 2018,"** by Purdue economist Larry DeBoer, charts these changing local fiscal conditions. And as the COVID-19 pandemic reduces revenue capacity across the state, it now doubles as a roadmap to areas likely to be hardest-hit.

The report shows budget pressure building in urban counties, as revenue potential also falls behind costs in many fast-growing suburban and metropolitan areas – the same places where population and employment density anchor much of Indiana's economy. It shows the negative effect of manufacturing losses on industrial counties that have failed to diversify, and the financial stability that agricultural assessment and tax policies have brought to rural parts of Indiana.

What the study measures – the **Revenue Capacity-Service Cost Index**:

The Capacity-Cost Index measures the ability of local governments to provide public services within state average tax rates. Revenue capacity uses county-by-county taxable income, property values and state aid for schools and roads, compared to per capita service costs adjusted for the percentage of population living in cities and towns versus unincorporated areas along with factors like school enrollment and road miles. The Index distills this data into one value.

A lower Index means more difficulty covering expenditures without raising taxes; a higher number means flexibility to adjust taxes and spending (though all local governments operate within income tax rate limits and maximum tax levies).

What the Capacity-Service Cost Index tells us about local governments across Indiana:

Urban counties face greater fiscal challenges, while population growth also adds budget stress:

- From 2002 to 2018, more urban areas declined into negative Capacity-Cost territory; they face higher per capita costs, but also higher circuit breaker losses and growing reliance on local income taxes in the property tax cap era.
- 28 of Indiana's 92 counties saw 5% or higher population growth since 2002, but also experienced a collective drop in Capacity-Cost Indexes (while slow or no-growth counties improved) as costs grew faster than revenues.
- New residents bring new revenue – assessed value growth, taxable income, state school aid, etc. – but property tax caps and the increased homestead deduction (raised to $45,000 after 2009) seem to push capacity below costs in places with heavy residential development.

Indiana's dominant industry – manufacturing – has played a key role in Capacity-Cost changes over time:

- Counties with high concentrations of traditional manufacturing in the 1970s often suffered significant job losses over the next forty years (part of a much broader trend) and declining Capacity-Cost Indexes.
- Counties that struggled to rebuild after domestic automotive declines continue to deal with dire budget conditions; communities that were able to diversify and replace manufacturing jobs regained their fiscal footing.

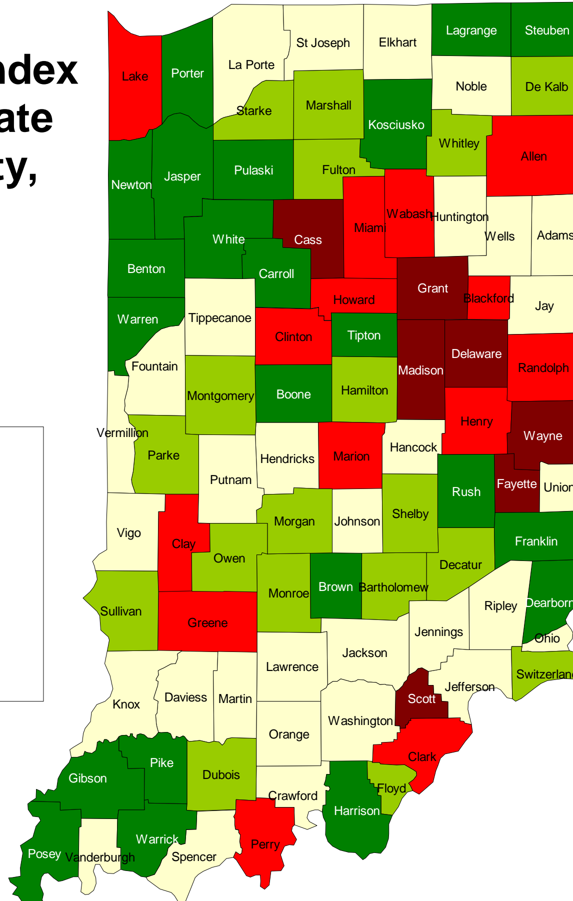
Rural counties have improved their Indexes since 2002; the agricultural property tax base has been strong & stable:

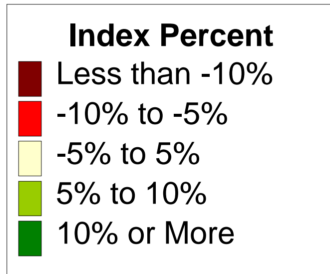
- Rural populations may be declining, but so are their (per capita) service costs…and farmland remains as residents leave: The agricultural 'base rate' per acre for property taxes has tripled since 2002.

- Agricultural assessments increased with 2003 reforms, trending during the favorable farm economy of 2007-2014 (assessments have dropped since 2015, however).

These trends are depicted in the map below:

Capacity-Cost Index as Percent of State Average Capacity, 2018





- Roughly 60% of Hoosiers lived in counties with a negative Capacity-Cost Index in 2018.
- Most urban counties are negative (St. Joseph and Vanderburg modestly so, at -65 and -18 respectively), more so than in 2002.
- However, fast-growing urbanized counties like Hamilton and Porter are positive – but less so than in 2002: Population growth tends to add fiscal stress to local government.
- A dozen counties in an east-central corridor have very negative Indexes due to manufacturing job, income and assessed value decline.
- Outside this 'automotive belt,' counties with notably negative Indexes include Scott (-439), Marion (-248) and Lake (-215).
- On the positive side, counties with >15% of assessed value in farmland gained the most capacity ($831) and saw the biggest Index increase (258) from 2002-2018.
- Maximum levy limits mean rising capacity tends to reduce property tax rates rather than increase spending significantly in 'green' counties.

Why is the Capacity-Cost Index analysis so important now?

- The 2018 Capacity-Cost Index is a baseline of the fiscal conditions of local government after nearly a decade of recovery; the COVID recession will reduce revenue capacity (and increase many costs) across the board, accelerating some of the negative trends captured in the 2002-2018 analysis – particularly in urban counties.
- These urban and metropolitan counties are also likely to lead Indiana's economic rebound (and drive population growth), but will rising budget stress (and rising tax rates – see below) impair their ability to rebuild from COVID?
- For context, the (seventeen) urban counties account for 62% of the state's population (and nearly all Indiana's net population growth projected for 2020-2050), roughly 70% of economic output and total employment, and generate nearly half of all state taxable sales (as sales tax revenue in turn makes up half Indiana's general fund).
- With higher per capita costs and a limited tax base, these governments already face the necessity of higher-than-average tax rates – however, this pushes more properties to their constitutional cap limits, creating a cycle of greater circuit breaker losses, more rate increases and worsening budget stress (as measured by the Index).
- In places with very positive Indexes, the maximum property tax levy restricts the total revenue local governments can collect; facing potential cutbacks in state funding for roads and community/economic development programs, rural counties could confront a different challenge – lower tax rates, but limited resources to address local needs.
- All local governments will face revenue losses, pushing more counties on the map above "into the red" in trying to balance a competitive tax climate with public safety, roads and other basic services and quality of life priorities.