INDIANA FISCAL POLICY INSTITUTE
SINCE 1987

December 14, 2021

Indiana Fiscal Policy Institute Issue Brief

The Big Short: State Revenues, Tax Relief and the 2022 Legislative Session

On Thursday, the State Budget Committee will receive the annual forecast of Indiana general fund revenues, updating April's projections for tax collections supporting the FY2022-2023 biennial budget. The forecast could also be a prelude to tax relief in next year's session of the General Assembly: While a non-budget short session typically focuses on issues without significant fiscal impact, these are far from 'normal' times for state finances.

This brief provides a refresher on the current revenue climate leading into the December 16th Budget Committee presentation and a discussion of tax plans that have been floated publicly by legislative leaders.

The Pressure for Tax Cuts:

Indiana's budget surplus is again growing beyond $3.5 billion (based on revenue collections and the current budget plan) less than six months after announcing nearly $1.1 billion divided between automatic taxpayer refunds and public pension stabilization from a FY2021 close-out that saw reserves nearly hit $4 billion:

- Tax collections beat the mid-April forecast more than a billion dollars over the last quarter of FY2021.
- On an annual basis, sales tax revenue grew 12.8% in FY2021 over 2020, and both individual and corporate income taxes easily boasted double-digit year-over-year growth even after adjusting for more than a billion dollars in income tax payments delayed from FY2020 to 2021 due to the extension of the tax filing deadline.
- This growth trend has continued through the first five months of FY2022, as general fund revenues have continued to exceed monthly estimates by a total of $644 million ($647 versus the budget plan) as of November 30th.

This has intensified discussion around permanent tax cuts beyond the automatic income tax refunds triggered by limits on state reserves. The 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 the Indiana Fiscal Policy Institute's Annual Meeting in late October and other public forums and media reports.

Governor Holcomb and Senate Republican leaders have adopted a wait-and-see attitude ahead of Thursday's forecast, with the updated outlook likely to crystallize attitudes about the feasibility and scale of any proposal.

COVID caused only a temporary drain in Indiana's rainy day funds, before rebounded to test statutory controls aimed at keeping reserves from growing beyond 12.5% of annual expenditures. (An automatic transfer of balances above $2.5 billion to teacher pensions at the end of FY2022 included in the budget seems inevitable.)

But there's also a philosophical difference over whether the surplus represents the over-taxation of Hoosiers or a deficit of spending on public goods and services. This brief will address two more straightforward questions:

Are competitive pressures from other states pushing Indiana to reevaluate our tax climate?

Would reducing taxes in 2022 create long-term revenue challenges past the current biennium?

The Competitive Landscape:

Indiana is certainly not alone in experiencing better-than-expected revenue recovery from COVID; in fact, a third of states have already capitalized on the favorable budget climate to cut taxes in 2021.

Analyses by the [Tax Foundation] and [Fitch Ratings] (more from Fitch later) identify eighteen states that enacted policies reducing net revenues, some by less than 1% of annual revenues and at least two permanent tax cut packages projected to reduce revenues by 5% or more (Arizona and Iowa).

Vermont reduced statewide property taxes, Tennessee passed a two-week sales tax holiday, and several states took aim at various business taxes. ***But most commonly, relief focused on personal income taxes.***

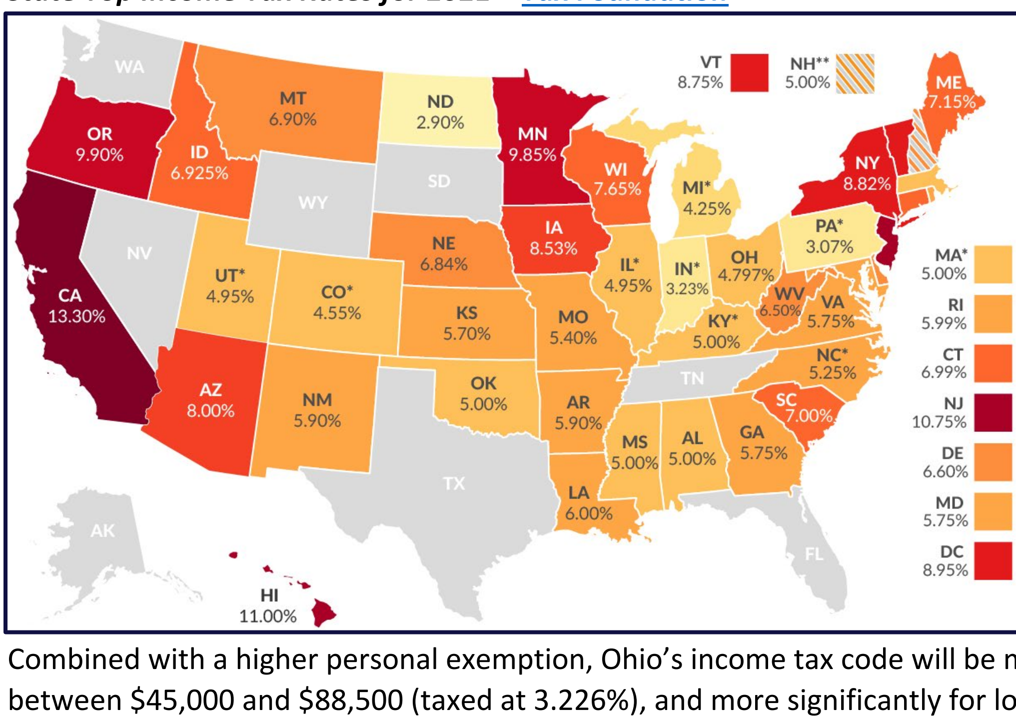
Twelve states either cut rates or expanded exemptions in 2021, including Ohio (more detail below). A thirteenth, New Hampshire, began a five-year phaseout of taxes on personal investment and dividends. So it's no surprise that cutting or expanding exemptions to Indiana's flat 3.23% individual income tax has surfaced.

Individual Income Taxes:

Reducing individual income taxes (beyond the automatic tax refunds already scheduled for 2022) has been advanced as the most straightforward way to deliver broad tax relief to working Hoosiers. The individual income tax is Indiana's second-largest source of general fund revenue, and grew roughly 12% over the last state fiscal year (again, even adjusting for the effect of the delayed tax deadline in 2020) as higher-wage employment led the way in recovering from the COVID economic shock.

The map below (courtesy of the Tax Foundation) shows current state income tax rates; the top rate in 2021 is listed for the majority of states with a graduated tax. Indiana already boasts one of the lowest state (and combined state/local) income tax burdens in the nation, particularly among our Midwestern neighbors.

State Top Income Tax Rates for 2021 – Tax Foundation



Even with no change to the status quo in 2022, Indiana's flat rate will be lower than any of the top rates of the dozen states that cut income taxes this year. (Indiana is bordered by three of the nine other states with a flat state income tax: Illinois, Michigan and Kentucky.)

Closest to home, Ohio acted to reduce rates across the board, collapsing its top two brackets with a steeper cut to 3.99% for income above $110,650. Combined with a higher personal exemption, Ohio's income tax code will be modestly friendlier for incomes between $45,000 and $88,500 (taxed at 3.226%), and more significantly for lower-income households.

However, more than 600 Ohio municipalities levy local income taxes, with average rates around 2% versus Indiana's average local (county) rate of 1.6%. Ohio also allows local option sales taxes, with the [average combined state and local rate] (7.17%) topping Indiana's state (only) rate of 7%. But beyond the Hoosier-Buckeye border rivalry, what broader benefit could accrue from potential income tax reform?

Does cutting the state income tax make Indiana more appealing as a place to live and work?

- ***Indiana's current combined state and local income tax burden is nearly 20% less than the 50-state average*** (based on 2021, acknowledging this advantage will narrow with the actions taken by other states).
- Of the states that could overtake or outpace Indiana in total state and local income tax burden after cutting rates in 2021 (e.g. Oklahoma, Kansas, Arizona, Idaho), none are among our closest competitors for population and employment growth; as noted above, Indiana maintains an overall edge over Ohio.
- Ohio lawmakers are also debating tax and other incentives aimed at retaining in-state college graduates: However, an analysis of Census data on Americans' reasons for moving from 2015-2021 shows that the primary motivations for residential moves are personal/family issues (28%), job-related changes (22%) and housing/community attributes (37%), with taxes lagging among a list of "other" factors that add up to 11%.
- Reducing an already-modest income tax rate seems unlikely to spur in-migration to Indiana; in cases where regional population growth may be influenced by comparative tax burden (Illinois to northwest Indiana, for example), the advantage already appears to exist.

Looking at the bigger picture:

Indiana's overall state and local tax burden is consistently lower than the 50-state average, in terms of per capita collections but also (in a measure that accommodates earning power and cost of living variations) as a percentage of state income: 8.9% of income for Indiana versus 10.3% across the rest of the nation.

In this context, it's difficult to argue that Hoosiers pay an unreasonable cost for their state government, as individual households or in the form of business taxes: Indiana also boasts a more favorable ratio of business taxation-to-total-revenue than the average state, according to the State Tax Research Institute and the Council on State Taxation. Indeed, the state's tax climate is routinely lauded as a competitive advantage for individuals and employers alike.

However, it's just as difficult to make the case that Indiana can't "afford" to return more of our surging revenues to its taxpayers. But should tax reductions be permanent?

Revenue & Budget Stability:

The last eight months have brought a truly unprecedented surge in state revenues; it's unrealistic to expect this trend to evolve into a "new normal." Fitch Ratings recently issued a cautionary statement on the tax cut trend:

"U.S. states reduced taxes to a greater extent than anticipated during this past budget season, with some of the biggest changes likely to necessitate difficult budget choices in the future, Fitch Ratings says. Fitch considers a state's ability to maintain fiscal balance when evaluating the credit implications of tax changes…some states are now in a more vulnerable position should revenue growth slow and return to pre-pandemic patterns. Budget challenges, such as the rolling off of federal aid and a shift in consumer spending away from goods toward services, many of which are not taxed, are likely to curb state revenue growth over the medium term."

Unlike states singled out for "impractical" cuts by Fitch (Kansas and Arizona), **Indiana can point to a consistent commitment to preserving prudent levels of reserves:**

- Over the decade leading into last year's unexpected surplus – FY2011-FY2020 – Indiana's reserve balances averaged $1.9 billion, over 11% of average annual general fund expenditures over the same time period.
- Notably, this 10-year average is depressed by FY2020 (when revenues were hit by the economic effects of COVID and the fiscal impact of the delayed tax filing deadline) and FY2011, when reserves were being rebuilt from the Great Recession.

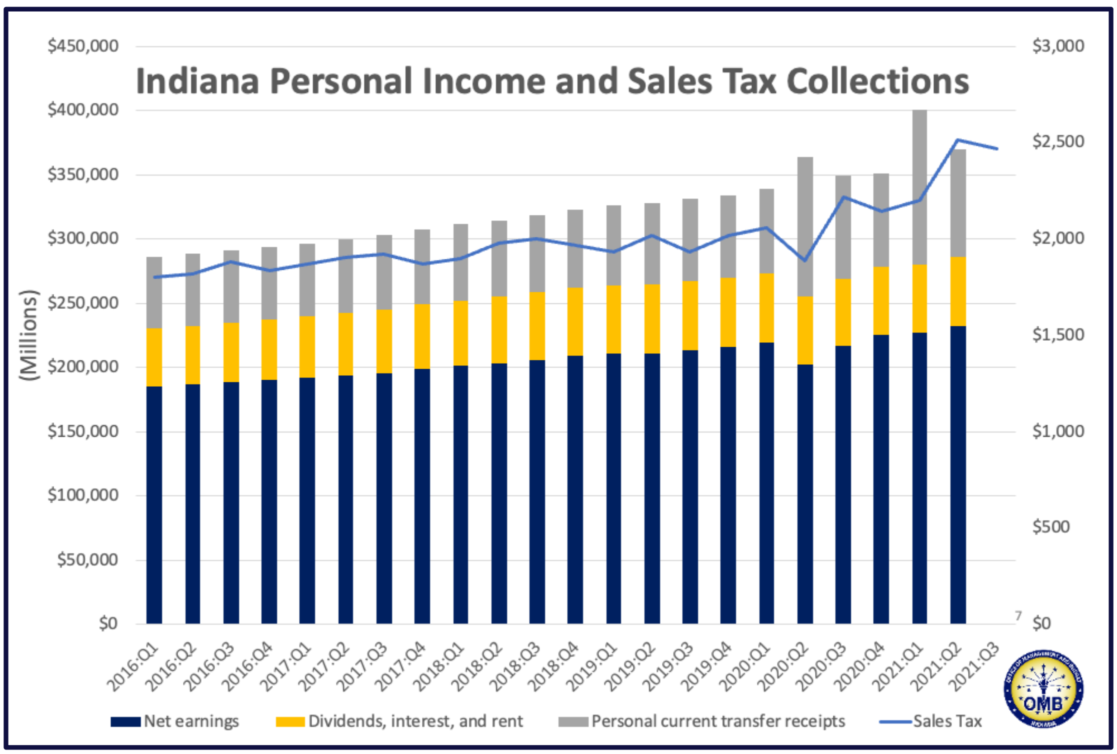
Indiana personal income also outpaced the nation through the COVID recession (Q42019 through Q22021), at a 4.3% annualized growth rate versus 4.1% (U.S.). Importantly, a closer look at this data via the Pew Trusts reveals that net earnings contributed more to Indiana's personal income gains than the average state, though every state benefited from elevated transfer payments (federal aid) boosting incomes through 2020.

Narrowing the Tax Base:

By these metrics, permanent tax relief poses less fiscal risk to Indiana than other places, but there is another concern that accompanies an income tax reduction in particular. Indiana's sales tax accounts for the majority of our general fund revenue; as the chart below (via the Council on State Taxation) indicates, we depend significantly more on the sales tax as a share of total state and local collections than the average:

State	Total Burden: % of Income	Property	General Sales	Individual Income	Corporate Income	Excise/ Other
Indiana	**8.9%**	**25.3%**	**28.5%**	**23.6%**	**2.6%**	**20.1%**
50-state avg.	***10.3%***	***31.1%***	***23.3%***	***24.2%***	***3.2%***	***18.3%***
Illinois	11.1%	38.3%	18.4%	20.2%	3.4%	19.7%
Kentucky	9.9%	21.3%	20.3%	33.9%	3.9%	20.6%
Michigan	10.0%	33.1%	22.3%	24.5%	2.5%	17.7%
Ohio	10.3%	29.2%	26.8%	26.7%	0.5%	16.8%

Reducing income tax revenue would leave the state's budget outlook tethered even more tightly to the stability of sales taxes. The chart below, presented by Indiana Office of Management & Budget Director Cris Johnston at the Fiscal Policy Institute's Annual Meeting in October, shows the correlation between transfer receipts (federal stimulus and enhanced unemployment), personal income and spikes in sales tax collections fueled by consumer spending. There's an obvious risk to increasing reliance on the sales tax beyond the timeline of federal COVID aid, with consumer spending roiled by inflation concerns and future uncertainty.

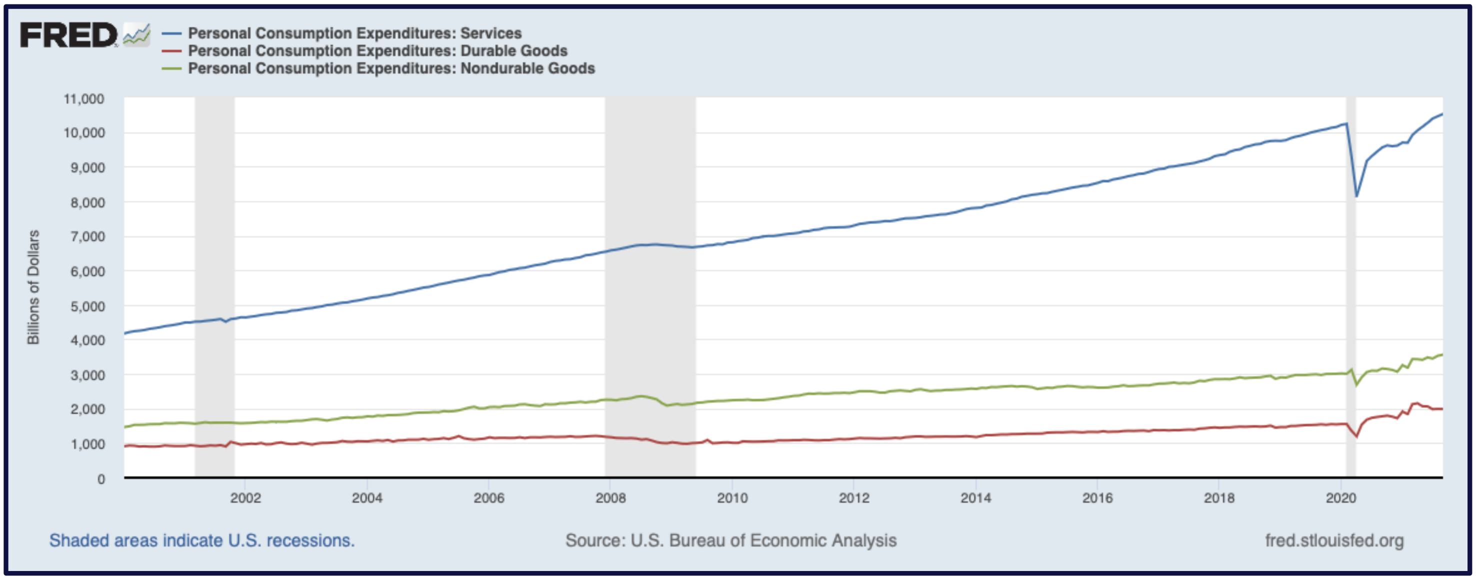


Strengthening the Sales Tax:

There is a way to bring more certainty and stability to Indiana's sales tax to mitigate this risk, by broadening its base to include services. Hoosier spending on services took an obvious hit in 2020 – service-oriented businesses bore the brunt of public health closures, capacity restrictions and cautionary behavior by consumers. Spending on goods was more modestly affected (a saving grace for state revenues in the early months of the pandemic), but service spending is quickly resuming its pre-COVID trajectory.

Indiana personal consumption spending – services, durable and non-durable goods:

January 2020 – August 2021 (recessions noted by gray shading)



House Ways & Means Chairman Brown has championed [an expansion of the sales tax to include some services](), in tandem with a rate reduction to achieve revenue neutrality while strengthening the base. There have been some indications that he will seek to revisit the issue in his final session in the General Assembly.

But any such proposals would provoke fierce lobbying and debate. Healthcare and construction represent the largest two categories of service spending: Plans to tax transactions in these areas would be fraught with policy and political implications at a time when medical costs and housing affordability are also on the list of pocketbook concerns for many Hoosiers – especially within the scheduling confines of a short session.

Forecasting Revenues, Peering Over the Fiscal Cliff:

Some of the questions about Indiana's revenue outlook will be answered on December 16th, at least providing a set of common guardrails to guide debate during what could be a big short session for tax relief in 2022.

Looking further ahead, 2023 reopens a broader debate over Indiana's tax burden and spending priorities with the negotiation of Indiana's 2024-2025 biennial budget. Governor Holcomb has already signaled his intent to seek more resources for the READI grant program, backed by federal dollars in the current budget. Demands for investments in broadband deployment, water systems and transportation infrastructure are also unlikely to wane beyond the timeline of the American Rescue Plan Act.

Nor will it be easy to recalibrate expectations among educators and school corporations should revenues fail to support per student tuition support adjusted for inflation and enrollment.

The potential for tax reform will become clearer with this week's revenue forecast, but will influence spending priorities and the curve of Indiana's finances long after the turmoil of the last two years has filtered out of our economy and tax base.