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Study shows pre-COVID fiscal climate for local government:

Revenues not keeping up with costs in urban counties & manufacturing regions as rural areas get boost from farmland assessments, says Indiana Fiscal Policy Institute

INDIANAPOLIS: A new Indiana Fiscal Policy Institute (IFPI) study shows budget pressure building for local governments serving the most populated parts of the state, even before the COVID-19 pandemic. Urbanized and faster-growing communities face increasing fiscal stress, as do counties with declining manufacturing employment. In contrast, agricultural assessments add stability to rural counties, according to **"Capacity-Cost Indexes for Indiana Local Governments - 2002 and 2018"** authored by Purdue economist Larry DeBoer.

"Professor DeBoer's work shows that economic, demographics and policy shifts are pushing local revenue capacity below costs in counties where most Hoosiers live and work," said IFPI's Chris Watts, noting that nearly 60% of Indiana's population lives in areas with negative fiscal conditions. "These places are already more challenged to keep budgets in balance, an ominous starting point before adding the impact of COVID."

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

The Capacity-Cost Index distills this data into a single value: A negative Index means more difficulty covering expenditures without raising tax rates. A positive Index means more flexibility to adjust taxes and spending, though all local governments operate under state-imposed limits on income tax rates and property tax levies and bills (so property tax rates rise and fall with the Index more closely than actual spending levels).

"The Capacity-Cost Index doesn't examine actual local tax rates and budget priorities, but how average revenue collections would align with costs in each county," DeBoer explained. "The Index shows the fiscal conditions facing local officials – shaped by state policies on property tax collections and levies, income taxes, funding formulas for education and infrastructure and so on, along with economics and demographics."

The study calculates a 2018 Index along with a 2002 version to look at trends over time, spanning economic recession and recovery and capturing the impacts of significant tax reforms, including property tax caps.

"We see a divergence in Capacity-Cost Indexes since 2002, when more counties were clustered around the statewide average," DeBoer added. "By 2018, most urban areas had declined into negative territory, while rural counties became more positive. Population growth has tended to lower Indexes as well."

Among the key findings revealed by the Revenue Capacity-Service Cost Index:

Revenue Capacity and Population Growth:

Local revenues are constrained by property tax caps and maximum levy limits that were tightened after 2002. The homestead deduction (raised to $45,000 in 2009) further reduces capacity growth as new residents bring added costs – the 28 counties that experienced 5%+ population growth since 2002 saw a collective decrease in Capacity-Cost Indexes.

“Revenue capacity does expand with population, adding taxable income, assessed value and education aid as funding follows enrollment,” DeBoer said. “But the homestead deduction seems to tip the Cost-Capacity balance in counties with strong residential growth, reducing taxable assessed value by $73 billion in 2018.”

Watts called the correlation between population gains and capacity deficits “troubling.”

“This study suggests that our current tax structure makes it difficult for our fastest-growing communities to keep up investments in infrastructure, public safety, other necessary services and quality of life initiatives,” he said. “These are the very places we need to rebound and lead the recovery as we re-open our economy.”

Farmland and the Urban/Rural Divide:

Local fiscal conditions have shifted since 2002: More (mostly urban) counties fare significantly worse than the state ‘average,’ while many rural counties have steadily improved. Rural populations are declining, but service costs have decreased as well (though not as the same pace, as some ‘fixed’ costs – like maintaining existing roads – continue regardless). School costs grew more slowly as enrollment decreased in most places.

At the same time, capacity growth tracks closely with a county’s share of farmland. The agricultural ‘base rate’ per acre has tripled since 2002. Farmland assessments increased with the reforms in 2003 and assessment trending during the favorable farm economy of 2007 to 2014. Maximum levy limits (tied to non-farm personal income growth) force most of this added capacity to lower tax rates instead of increasing spending. Lower tax rates also mean less revenue lost to property tax caps in rural communities.

In contrast, urban counties (17 with populations over 100,000) face higher per capita costs, more overlapping layers of government, steeper losses under the tax caps and capacity outpaced by service costs since 2002.

“Urban areas are already struggling to balance a competitive tax climate with necessary services,” Watts said. “In rural Indiana, tax rates may be lower, but local resources are still limited by maximum levies.”

Manufacturing Trends over Time:

Longer-term declines in traditional manufacturing employment limited capacity growth in many industrial counties. A large number of Indiana counties had heavy concentrations of manufacturing in the 1970s, but job losses over the next forty years limited growth of taxable income and assessed value. This widened the gap between revenue capacity and costs, increased property tax rates and caused large revenue losses to tax caps, especially in places that weren’t as successful in replacing lost jobs with employment in other sectors.

In particular, manufacturing losses decimated the tax base across east-north-central Indiana, giving a dozen counties along this corridor negative Capacity-Cost Indexes in 2002 that worsened considerably by 2018.

“Indiana continues to be the most manufacturing-intensive state in the nation,” Watts noted. “The Capacity-Cost Index shows the impact of our manufacturing sector and the importance of diversifying employment – counties that were able to rebuild after manufacturing losses were better able to regain their fiscal footing.”

The 2018 Revenue Capacity-Service Cost Index identifies a pattern of fiscal distress after nearly a decade of economic recovery – a recovery that ended dramatically with the COVID-19 pandemic. As Indiana rebuilds from COVID, DeBoer expects the most daunting challenges to mirror the geography of the 2018 Index.

“The COVID-19 recession will reduce the capacity of local governments statewide,” DeBoer said. “Falling taxable income will reduce local income tax distributions, a sluggish real estate market will impact assessed values and property taxes. The next state budget could limit aid to schools, and fuel tax revenue for local road construction is already down. But the impact will be amplified in places already facing budget stress.”

“Counties with negative Capacity-Cost Indexes already tend to have higher property tax rates, and less potential to raise revenue under the caps. So the communities struggling today to deliver public services with limited tax bases will be affected most harshly into the future.”

A summary of the study accompanies this release; the full report can be downloaded here.

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Larry DeBoer is a professor and extension specialist in Agricultural Economics at Purdue University. DeBoer joined the Purdue faculty in 1984. He studies state and local government public policy, including such topics as government budget and taxing options, issues of property tax assessment, local government revenue options, and the fiscal impact of economic development.

Professor DeBoer worked with the Indiana Legislative Services Agency on tax and finance issues from 1988 to 2014, and continues to contribute to LSA’s annual property tax analysis. DeBoer directed a study on market value property tax assessment for the Indiana State Board of Tax Commissioners during 1995-97, and oversaw the staff work for Governor O’Bannon’s Citizen’s Commission on Taxation, 1997-98. A decade later, he contributed research to Governor Daniels’ Commission on Local Government Reform (2007). DeBoer was the 2009 recipient of Purdue’s Hovde Award for service to the rural people of Indiana.

About the Indiana Fiscal Policy Institute:

The Indiana Fiscal Policy Institute (IFPI) was founded in 1987 and continues to operate as Indiana’s only independent research organization focused on state and local tax and budget policies. IFPI is a 501(c)3 non-profit institute that does not lobby, support political candidates or engage in other partisan activity. Learn more about IFPI and its work at www.IndianaFiscal.org and follow @IndianaFiscal.