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Report 27

INDIANA ECONOMIC HURRICANE

Focus Now Shifts to Damage Assessment and Rebuilding

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Fiscal Policy Report 27

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EXECUTIVE SUMMARY

Even after a special session and rare second revised revenue forecast, Indiana's collections to date are about 8 percent below the May revised forecast. The current recession has put the state's finances under extreme pressure and the end is not yet in sight.

The longest and deepest recession since the Great Depression has had a major impact on Indiana's economy:

- Unemployment is at its highest level since 1982.

- The lag in state tax collections is similar to that experienced after the recessions in the early 1980s and 1990s.

Indiana government reacted swiftly once the economic downturn became apparent in December 2008:

- The governor has ordered deep cuts in state programs.

- The General Assembly's budget that was signed by the governor intended to leave $1 billion in reserve, however this effort is hampered by the pernicious recession.

Indiana's relative economic strength means the governor and legislators have choices to deal with the recession, but they get increasingly difficult to contemplate:

- Preserving reserves until economic recovery is in sight.

- For additional cuts to be meaningful, they likely would include K-12 and higher education.

- The state could realize additional revenue through extending the sales tax to services.

If the state can maintain its present fiscal discipline and focus on rebuilding its economy, it may be positioned to emerge from the recession more quickly than surrounding states on a stronger economic footing.

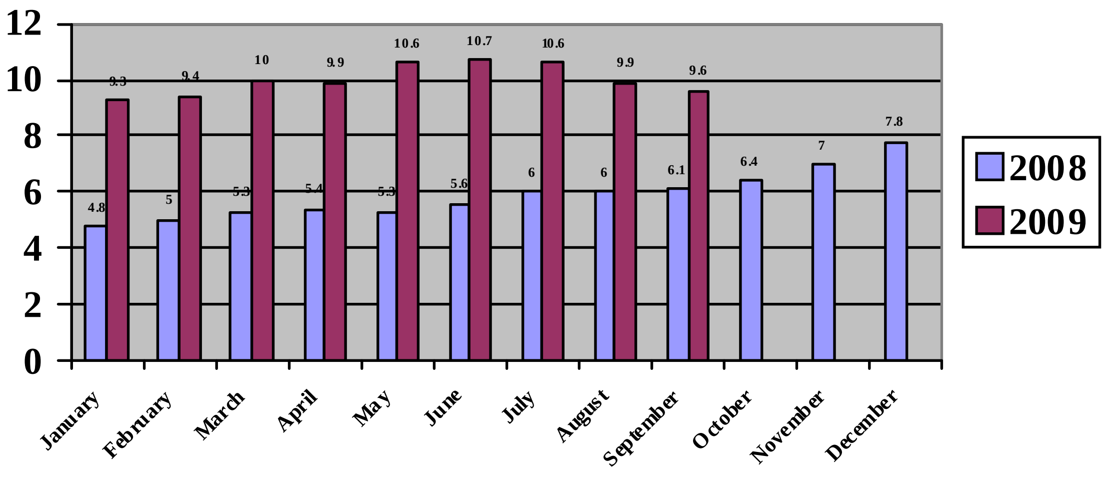
REPORT

Indiana's Budget – Picking up the Pieces

Devastating hurricanes are remembered by their names. Mention Andrew or Camille or Hugo or, certainly, Katrina, and the names evoke vivid memories.

When it comes to economic devastation little compares with the Great Depression of the 1930s. The current recession is nearly 24 months old, the most durable economic downturn since the Depression. While some could contend the early 1980s downturn was tougher on Indiana, the current recession already is seven months longer and has wrought economic hardship from Angola to Evansville. The storm's still blowing, too, despite the recent downward tick in unemployment and evidence of modest growth in the national economy.

Unemployment Rate
(Source: Bureau of Labor Statistics)



Indiana's General Assembly approved a relatively conservative budget in June, though it took a special session and an extra revenue forecast. Spending from the General Fund was set at $13.6 billion for the current fiscal year. That's 5.6 percent less than was budgeted for fiscal 2009, which ended June 30. The new budget anticipates spending $14.1 billion from the General Fund in FY 2011, a 3.7 increase from FY 2010.[i]

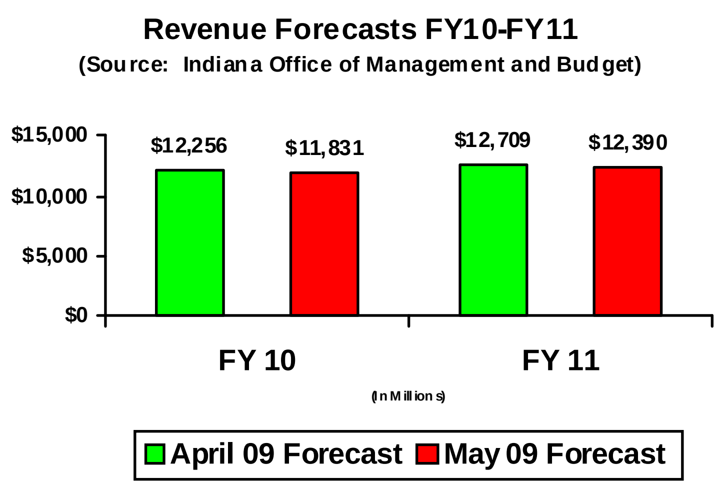
The budget included nearly 23 percent more money for primary K-12 education. Most of the increase, however, is attributable to the fact that the state now funds 100 percent of K-12 education. The budget calls for a 2.1 percent increase in FY 2011 to $6.56 billion. K-12 education accounts for more than 47 percent of the General Fund budget.[ii]

Other modest increases in the budget for higher education and health and human services are largely paid for with funds from the more than $4 billion Indiana will receive from the federal government through the American Recovery and Reinvestment Act.[iii]

Storm damage

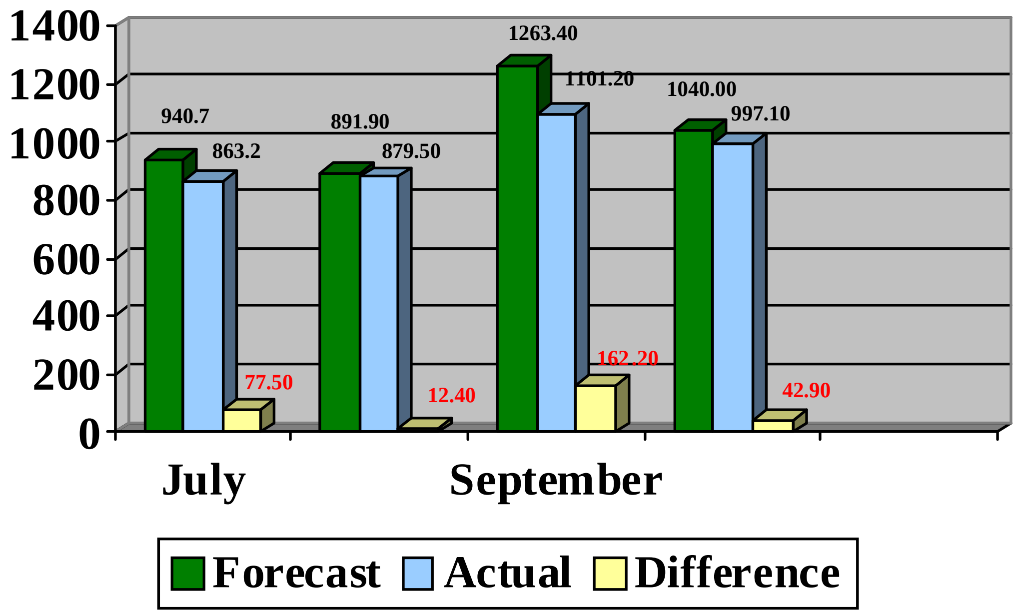
The economy, however, took little heed of the General Assembly's work. Unemployment remains near 10 percent across the state and is much higher in several regions of the state. The Elkhart-Goshen area's unemployment rate remains an estimated 15 percent in October, according to the U.S. Department of Labor's Bureau of Labor Statistics. Unemployment in the Kokomo area was 11.6 percent, though both figures are vast improvements since reaching highs last spring.[iv]

Few are surprised that the higher unemployment rate has had a major effect on Indiana's revenue collections, specifically the sales tax, income tax and corporate income tax. Those effects were at the center of an unusual economic forecast revision May 27, just five weeks after the regular economic forecast was issued.



Still, overall revenue collections are 8 percent lower than expected in the first four months of the current fiscal year.

Actual Revenue vs. Forecast FY 2010
(Source: Indiana Office of Management and Budget)



Sales tax collections are down 4.6 percent while the individual and corporate income tax collections each are off 14.1 percent. Tax revenue from gambling, however, has bucked the downward trend. The state has collected $15.2 million, or 11.4 percent, more than expected.[v]

Forecasting Misery

Are the missed recent economic forecasts an indictment of Indiana's process? No. More probable is that the models used to anticipate sales and income taxes no longer accurately reflect economic activity. This recession's unusual depth and duration has meant weaker consumer spending than a more typical downturn would produce. Likewise, the prolonged period of high unemployment and employers' hesitance to add jobs has slowed any economic recovery.

Forecasting revenue is especially difficult as the economy turns, whether up or down. The revised forecast in December likely will be more accurate because forecasters will be further from the downward turn.

Indiana's missed forecasts are not unique. Michigan and Wisconsin recently reported their forecasts missed by wide margins and most states have had similar results.

The process that Indiana uses to reach its revenue forecast, however, is seen by many as a model for other states to emulate. The process results in a consensus revenue figure because fiscal aides representing the governor and the Legislature discuss the information and reach a consensus before the forecast is issued. So the debate occurs over spending or cuts to spending, not over the state's revenue expectations.

Clearly Indiana's suffering economy has had a negative effect on the state's budgeting process and fiscal outlook. Worse, the winds of recession still are blowing.

<u>Responding to the storm</u>

Emergency response to any crisis is best judged after the event when all actions can be weighed in the final context. It's fair, however, to characterize Indiana's early response to the recession and its related fiscal damage as aggressive.

Gov. Mitch Daniels ordered a 10 percent reduction in expenses for all state agencies Nov. 6, the same day he announced that October revenues were 4.1 percent less than expected. It was the second time the governor has imposed such cuts in the last 12 months. State hiring is flat and employees will go a second year without raises. Automatic overtime in the Department of Corrections was eliminated while overtime pay in other agencies was sharply reduced. State workers are being encouraged to take unpaid days off. The governor also said that the state will reduce Medicaid reimbursements 5 percent to hospitals beginning Jan. 1, a move Governor Daniels said he'd hoped to avoid just the week before.[vi]

These and other cuts are meant to reduced state spending by about $500 million and are meant to ensure the state maintains about $1 billion in reserve funds when the current budget expires June 30, 2011.

Indiana Reserve Fund Balances
(Source: Indiana Office of Management and Budget)
(In Millions)

	FY 2009	FY 2010 (forecast)	FY 2011 (forecast)
General Fund	$ 54.90	$ 221.20	$ 143.80
Medicaid Reserve	57.60	57.60	57.60
Tuition Reserve	941.70	720.70	425.00
Rainy Day Fund	365.20	370.90	381.60
<u>Total</u>	**$1,419.40**	**$1,370.40**	**$1,008.00**

If revenue continues to miss forecast at the current rate, however, those reserves could be depleted by next August, just one month into the next fiscal year.

While the current budget did not anticipate additional federal stimulus funds, it did assume economic recovery to the extent that General Fund revenue would increase 2.1 percent. And that is why there is so much anxiety over the missed revenue forecasts.

What Does the Future Hold?

Indiana's fiscal position relative to other states gives it choices for managing the budget during this recession.

If state tax collections remain in decline, the first choice to consider is spending down reserves. That is complicated, however, by the downward trend in state tax collections. At this point the governor has made a case to maintain reserves until recovery is within sight.

The governor could choose further spending cuts. Given the depth of cuts already to general government and, recently, Medicaid, the only meaningful way to cut spending is to include K-12 and higher education. The state is the sole funding source for the operation of local schools due to recent changes that remove local property tax revenue from the tuition support formula. These cuts would leave local schools with fewer options, such as teacher layoffs, larger classrooms and program cancellations. A cut in higher education funding could mean higher student fees. Given the difficult economy and the large number of people turning to the higher education system for new skills, cuts seem to run counter to reality.

It's possible the state could implement measures used previously, such as delaying payments, to help balance the budget, but the Daniels administration has expressed disdain for such "gimmicks."

The Toughest Choice

The governor also has expressed his desire to avoid increasing taxes to boost state revenue and cover the current funding gap. This remains, however, a choice when it comes to addressing the state's revenue shortfall. At 7 percent, Indiana's already tied for second-highest sales tax rate. The General Assembly has long avoided changes to the income tax structure and the gambling industry seems an unlikely source for additional tax revenue given new competition from recently approved casinos in Ohio.

Raising taxes always is a politically difficult proposition, but it is especially difficult in a non-budget year when the entire House of Representatives and half of the Senate are up for election. And need we mention that whichever party controls the

House and the Senate after the 2010 elections also controls redistricting? It is hard to imagine a more difficult scenario for passing a tax increase.

There has been talk among legislators in recent years, however, of extending the sales tax to services. Indiana currently taxes 24 of 168 services tracked by the Federation of Tax Administrators. That places Indiana on par with its neighbors except Ohio, which taxes 68 services.

Estimated Revenues from a Sales Tax on Services
Indiana, Fiscal Year 2009-10
(in millions)

Types of Services	Gross	Assuming All Business Exemptions
Total Personal/Business Service	$4,594	$2,302
Personal/Business (Medical)	2,116	1,732
Personal/Business (Legal)	147	38
Personal/Business (Other)	2,331	758
Total Transportation Services	516	85
Total Construction Services	1,650	323
Total All Services	6,760	2,936
Total less Medical & Legal	4,497	1,166

* *Source: Legislative Services Agency; IFPI Calculations*

An Indiana Fiscal Policy Institute study released in October showed that Indiana could reap significant tax revenue from extending its 7 percent sales tax to services.[vii] The tax could gross as much as $6.7 billion a year, though it's hard to imagine any extension of sales tax without exemptions for medical, legal and all business-to-business transactions. Even with such exemptions the tax would raise an estimated $1.2 billion more a year, according to the IFPI study.

A Rationale

According to the October IFPI study:

"Expanding the base of the sales tax to include a broad array of services is attractive for several reasons:

"First, the services base is very large, is growing faster than the base of tangible personal property, and is likely to continue to grow faster[viii]. From the point of view of a state wishing to avoid a structural deficit, this is an obvious attraction.

"Second, to a degree, goods and services are substitutable. A person may receive a massage from a masseur or from a massage chair. The chair will be subject to the sales tax; the services of the masseur will not.

"Third, it may be argued that the tax on tangible personal property falls on many goods—clothing, for example—the consumption of which is not optional. There are, at the same time, purchases of services—greens fees and cosmetic surgery, for example—which, if not actually luxuries, are optional, but which escape taxation.

"Therefore, from the perspective of both revenue potential and equity, a sales tax on services has much to recommend it."

There are many potential problems associated with extending the sales tax to services. The report concluded:

"Of the major sources of revenue available to the state, broad-based taxation of services is the only one yet to be tapped by the State of Indiana. The revenue possibilities are great and it would bring a degree of equity to the tax system. At the same time, defining the base will be difficult, both conceptually and politically, and the cost of collecting the tax on the part of both the state and the taxpayers would be significant."

History suggests, however, that any extension of the tax to more services would be difficult. Poor execution doomed attempts to do so in Florida, Massachusetts and Michigan. Legislators in Michigan repealed the extension they approved in October 2007 just 17 hours after it took effect in December 2007.

Rebuilding

The General Assembly will receive a revised forecast in December. The results likely will not show much improvement in tax collections if any at all. Recovery from this recession will be a long slog, not a sharp upward bounce.

The same principles that have left Indiana with choices in this recession are the ones necessary to carry the state through to recovery.

- Maintaining healthy reserves is critical. Policy makers should continue to resist spending down the reserves to zero.

- Strong fiscal management must continue. It is difficult to make cuts to a budget that's already pruned, but the current course is the right one.

- If the recession continues, at some point the General Assembly should consider extending the sales tax to additional services.

- Creating new jobs is the surest way to rebuild Indiana's economy. Every fiscal decision made should include consideration of how it will affect businesses' ability to create new jobs in Indiana.

Many economists expect recovery from this recession will be slower than previously experienced. It will be many months before the economy shows real recovery and likely a few years before it reaches pre-recession levels. Whatever course the governor and the General Assembly pursue will depend on those economic conditions.

About the Author:

John Ketzenberger is president of the Indiana Fiscal Policy Institute. Before joining the IFPI, Ketzenberger covered politics and business for more than 20 years at Indiana newspapers, including eight years as a Statehouse correspondent. Most recently he was a columnist for the Indianapolis Star. Ketzenberger also is a panelist on Indiana Week in Review, a weekly political roundtable television program that airs statewide.

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[i] HEA 1001SS, 2009.
[ii] State Budget Directors transmittal letter to the State Auditor, July 2009
[iii] Ibid.
[iv] U.S. Department of Labor, Bureau of Labor Statistics database
[v] Indiana State Budget Agency
[vi] Press release from Gov. Mitch Daniels, Nov. 6, 2009
[vii] Indiana Fiscal Policy Institute Information Brief: Sales Taxation of Services in Indiana, October 2009
[viii] Ibid.