March 25, 2022

Fiscal Impact of the 2022 Indiana General Assembly

Highlights from the Indiana Fiscal Policy Institute

The Indiana General Assembly's 2022 short session was long on major issues – and fiscal implications – in its ten-week sprint from the opening gavel to adjournment well ahead of schedule in the early hours of March 9th.

This summary will discuss:

The details of* HB1002*, the tax cut package that makes a $6.6 billion cumulative impact by FY2031 *(pages 1-2)****;***

The potential implications of tax reductions for future budgets *(page 2)****, including K-12 spending*** *(page 3)****; and***

***The balance of Indiana's tax code heading into the 2030s – are we cutting our way into overreliance on the* sales tax?** *(pages 3-4)*

From individual to business taxpayers, a summary of the* personal property tax debate** *(page 5)*;***

How the legislature added to the state's* economic development *toolkit (and the influence of Ohio's Intel win) *(pages 6-7)****;***

And a* summary of other key legislation *impacting state and local finances *(page 8).*

As the session got underway, optimistic revenue projections had House leaders already clamoring to join the dozen states that had already seized on a stronger-than-expected fiscal rebound from COVID to cut income taxes in 2021. The Senate was skeptical about permanent tax cuts in a short session, but three months of tax collections confirming the December forecast swayed the formerly reluctant Governor Holcomb to embrace a deeper (though more gradual) income tax cut. The version of HB1002 that made it across the legislative finish line reduces Indiana's flat individual income tax rate from 3.23% to 2.9% in seven years while eliminating the utility receipts tax.

The Senate held firm on the commitment made in last year's final budget to transfer excess reserves at the end of FY2022 to unfunded Pre-1996 Teachers Retirement Fund (TRF) liabilities. (However, the transfer is capped at $2.5 billion, below the $2.6 billion anticipated by the latest revenue estimates and surplus statement.)

Key provisions and near-term impacts of the bill include:

- Income tax rate reductions beginning in January; the rate drops to 3.15% for tax years 2023 and 2024 before planned reductions to 3.10% for 2025-2026, 3% in 2027-2028 and 2.9% starting in 2029.
- Starting in 2025 (based on FY2024 general fund revenues), income tax cuts beyond 3.15% are paused if prior-year revenue growth falls below 2% (general fund growth in FY2023 is forecast at 1.7%).
- The utility receipts tax is fully eliminated next year, for a consistent impact of $220+ million in foregone annual revenue.

- With a partial state fiscal year affected by the 3.15% income tax rate plus the utility receipts repeal, the gross FY2023 impact is estimated at $315 million, offset by a potential $100+ million 'gain' from available reserves via the $2.5 billion Pre-96 TRF transfer cap for a projected **net revenue reduction of $207 million.**
- Looking ahead to the FY2024-FY2025, LSA projects the total net impact of HB1002 at **$875 million for the next biennium** (see Figure 1, summarized from the final fiscal note on HB1002).

Figure 1: Projected State General Fund Revenue Impacts of HB1002 *(Legislative Services Agency)*

Fiscal Year	Income Tax Impact	Utility Receipts Impact	Total General Fund
2023	$ (87.40)	$ (227.00)	$ (314.40)
2024	$ (181.50)	$ (222.90)	$ (404.40)
2025	$ (247.50)	$ (221.90)	$ (469.40)
2026	$ (318.20)	$ (221.90)	$ (540.10)
2027	$ (457.90)	$ (221.90)	$ (679.80)
2028	$ (608.00)	$ (221.90)	$ (829.90)
2029	$ (769.20)	$ (221.90)	$ (991.10)
2030	$ (942.10)	$ (221.90)	$ (1,164.00)

Longer-Term Implications of HB1002:

What is the overall budget impact of HB1002?

Indiana enters the second year of the current biennium with just over $19.1 billion in planned expenditures versus $20.4 billion in forecasted general fund revenue for FY2023, after adjusting for the initial net impact of HB1002. After paying down $2.5 billion in (Pre-96 TRF) teacher pension debt at the end of this year, this means the state will still enter a new two-year budget in FY2024 with a projected $4 billion surplus.

Overall revenue growth was already expected to slow in 2023, falling below 2% as individual earnings and employment growth is offset by declining sales tax collections as consumer spending shifts back to services from taxable goods (resuming the pre-COVID trend). Factoring in HB1002, general fund revenues increase about 1.3% in FY2023.

But even if revenues remain essentially flat into FY2024, the next budget should support annual spending increases near 4% while accommodating state income tax cuts and ample opportunities to make biennial commitments from the general fund (e.g. another round of READI grants, the planned $300 million IEDC 'deal closing fund' envisioned by SB361) to manage reserves above the threshold of another automatic tax refund.

There's less flexibility in the following budget cycle (covering FY2026 and FY2027) with the total two-year impact of the HB1002 cuts estimated at more than $1.2 billion.

Assuming consistent 3.5% annual increases in expenses versus a 3% growth rate in taxable income and 3.5% growth in sales tax collections (based on underlying pre-COVID spending trends on goods), the FY2026-FY2027 budget can be structurally balanced with total revenues roughly a billion dollars ahead of appropriations. But there is significantly less flexibility in this biennium, and overall revenue growth dips below 3% in FY2027.

A 2-3% revenue growth "no man's land" is the most difficult scenario under HB1002, lingering above the statutory trigger to pause additional cuts, but below baseline growth in general fund expenditures around 3%. Indiana's healthy reserves provide ample insulation against fluctuations in revenues or austerity measures, but mild budget pressures may build as Indiana phases in the final two rate cuts.

How will HB1002 impact K-12 funding plans?

The current state budget made historic investments in K-12 education in an effort to counter the similarly historic challenges posed to student learning through the pandemic as well as longer-term shortfalls in teacher compensation across the state. The $18.7 billion total for FY2022-2023 is a $1.9 billion increase over FY2020-2021, and represents half the state's biennial appropriations.

Indiana funds nearly all K-12 operating costs for local school districts; state aid generally 'follows the student' through a formula starting with general tuition support: This baseline funding per pupil is $6,250 for the 2022-23 school year, and has grown more than 4% annually since 2019.

As with the overall budget outlook, healthy reserves and post-COVID revenue performance means K-12 spending levels should be secure through the next budget, FY2024 and FY2025.

Again, uncertainty grows towards the latter half of the 2020s, as the cumulative 'cost' of the HB1002 tax reductions climbs towards $6 billion. Will forgoing these revenues start to affect the state's capacity for consistent increases in school funding?

It's unlikely that the pressure for continued growth in education aid will ease: Current funding dedicated to teacher salary increases is already being eroded by inflation, and the broader challenge of teacher shortages and turnover are prompting stopgap solutions like a new 'adjunct' teaching eligibility standard to fill classroom vacancies. Learning losses created by two years of disrupted instruction similarly defy short-term solutions.

While tuition support overall has seen significant increases in the last two budget cycles, the complexity grant – additional state aid for students living in poverty, set at $3,775 per pupil for 2022-23 – has increased barely 1% a year since 2019 despite broad recognition that a bigger boost is needed to close achievement gaps and increase graduation and post-secondary entry rates for students from lower-income households. Addressing this disparity would add to overall K-12 funding obligations.

If general fund revenue growth does dip below 3% in FY2027, the current trajectory of education expenditures could represent the flashpoint in the inevitable debate over tax cuts versus spending priorities.

Do cuts to Indiana's income tax increase the volatility of our revenue structure?

Another potential implication of HB1002 is the increased reliance on the state sales tax, and the uncertainty it may introduce into Indiana's revenue system.

The last time Indiana passed significant tax reform in a non-budget session was 2008, when Governor Mitch Daniels and the General Assembly capped individual property tax bills to fixed percentages of assessed value to protect taxpayers from the upheaval of court-ordered market assessments. Local property tax reform included a shift in state responsibility for school operating budgets, funded by raising the sales tax from 6% to 7%.

Since then, Indiana has lowered the corporate gross income and financial institutions tax rate from 8.5% to 4.9% over ten years starting in 2012. In 2013, then-Governor Mike Pence signed another multi-year individual income tax cut, taking the rate from 3.4% to the current 3.23% starting in 2017 while repealing the state inheritance tax.

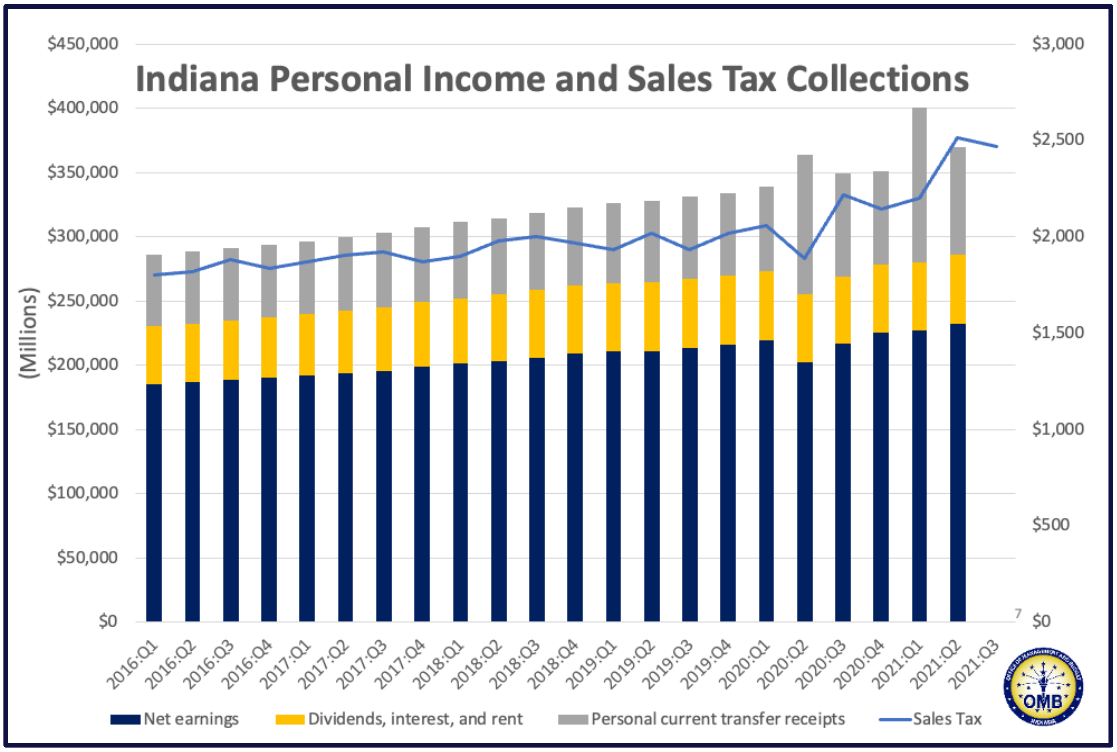
Gasoline taxes were raised in 2017, but revenues were gradually shifted out of the general fund and dedicated to infrastructure improvements.

Sales taxes were roughly 43% of Indiana's general fund before 2008. The ratio increased to 47% by 2012 and grew to nearly 50% in the past budget cycle. Factoring in the impacts of HB1002, the sales tax will account for about 53% of Indiana's total tax revenue by 2029.

Indiana is already 11th among states ranked by dependence on general sales taxes. For some states higher on that list – Florida, Nevada and Hawaii, for example – there are obvious economic reasons. Others, like Texas and South Dakota, tax a wider array of goods and services.

Indiana has maintained a fairly narrow base of taxable goods with common exemptions like grocery purchases. Spending on durable goods was a bright spot through the pandemic, as the service sector was hit hardest by capacity restrictions and changes in consumer behavior; fiscal stimulus also drove household consumption that directed impacted tax collections. *(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, personal income and sales tax collections through the pandemic.)*

Figure 2: Indiana Personal Income, Transfer Payments & Sales Tax Collections
(Indiana Office of Management and Budget)



But as service spending resumes its pre-COVID trajectory, the corresponding impact on goods will likely create a sales tax trend closer to 2016-2019. It's notable that the current revenue forecast predicts a slight decline in sales tax collections for FY2023.

Any proposals to broaden the sales tax to include services would provoke fierce lobbying and legitimate debate over the consequences beyond revenue stability. Healthcare and construction represent the largest two categories of service spending, and taxing these areas when medical costs and housing inventory and affordability are significant policy challenges would be a difficult argument.

Closing thoughts on HB1002:

With a surplus approaching $5 billion, it's hard to argue Indiana can't "afford" relief for the taxpayers beyond this year's scheduled refunds. It's also important to note that retaining the Pre-96 TRF transfer begins to pay off in budget savings in the early 2030s, as unfunded benefits are currently covered through the general fund at roughly $1 billion annually; paying down this liability helps mitigate some of the revenue impacts of the full schedule of income tax cuts.

But it's still important to anticipate and address the potential pressures on spending commitments (K-12 most notably) and structural challenges that could grow out of these cuts later this decade, depending on the durability of Indiana's economic recovery and competitiveness for population, income and employment growth.

Business Climate Considerations: What made the cut?

Moving from individual to business taxpayers, employers earned a favorable compromise on one of the highest-profile non-tax issues of the session, as less restrictive workplace rules on COVID vaccine requirements made the final version of HB1001 signed by Governor Holcomb to end the two-year public health emergency. But on tax and fiscal matters, the session drew mixed reviews from the broader business community.

Nothing personal – PPT relief left out of HB1002:
Many industry groups were dismayed that business personal property tax (PPT) relief was omitted from the conference report of HB1002. The original House plan sought to lower the 30% minimum depreciation floor built into PPT assessments of both existing and newly-purchased equipment.

Manufacturers and other capital-intensive business interests made a consistent case that this so-called "30% floor" keeps tax bills artificially inflated by freezing depreciation at a relatively high percentage of acquisition cost, even for equipment on the verge of obsolescence. House fiscal leaders agreed that the 30% floor constituted an anti-investment blind spot in an otherwise business-friendly climate, and Governor Holcomb endorsed a more limited approach lowering the floor for new equipment.

Business PPT also accounts for 17% of statewide property tax collections, provoking pushback from local government officials concerned about further losses against an already-limited property tax base. The House proposal allowed business taxpayers to claim state tax credits against the portion of their PPT burden attributable to the 30% floor, avoiding local revenue losses in exchange for roughly $300-400 million a year in offsetting state revenue replacement.

However, the House version of HB1002 was silent on the impact of new equipment, as these assessments aged towards 30% floor to eventually result in over $100 million lost annually to cities, counties and school districts. The Senate exerted a more protective attitude towards local budgets in stripping all new tax provisions in the Tax & Fiscal Policy Committee, and PPT language never re-emerged as Governor Holcomb's late-session support for income tax reductions became the focal point of the final bill.

Taxing tradeoffs – local budget climate, quality of life and housing in the PPT debate:
While the 30% floor on PPT has been identified as a disincentive to industrial investment, there's strong consensus among employers, economic development professionals and state policymakers that growing the labor force is an economic necessity with Indiana in its third consecutive decade of slowing population growth. Local public services and quality of life assets are front-line investments in talent attraction and retention, and should be weighed in that context against specific tax savings.

IFPI's 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 faster-growing urban and metropolitan areas as state policies gradually limited the property tax base since the mid-1970s, narrowing the largest and most predictable source of local revenues. Adding pressure to counties, municipalities and school districts by reducing PPT assessments (without state-level revenue replacement) would contradict the goal of programs like READI, as local revenues generated by population gains already fail to keep up with added costs.

PPT relief could also create unintended consequences for housing affordability, another issue impacting workforce availability and limiting growth potential in many parts of the state. Reducing assessments for business equipment reshuffles the total tax liability among other types of property, particularly as rising home prices increase assessments and therefore the 'cap' for residential property tax bills.

A recent report for the **Association of Indiana Counties** by Dr. DeBoer and former Senate fiscal analyst David Reynolds (with Policy Analytics LLC) and Purdue economist confirms that residential property is already shouldering more of the burden even under the current PPT system. Residential properties accounted for 42.5% of all collections in 2017, rising to 45.6% in 2021; the authors project homeowners will be responsible for half the total tax liability by 2026.

Upgrading the business attraction toolkit:
Even though HB1002 didn't provide PPT relief, the General Assembly did create some new tools to help Indiana outpace the competition for new employment and investment opportunities. In February, Indiana lawmakers took note of Intel's selection of Licking County Ohio as the site of a massive, $20 billion semiconductor manufacturing facility.

The Indiana Economic Development Corporation was continuing a five-year streak of successive record-breaking results in 2021 as newly-appointed Secretary of Commerce Brad Chambers preached a more place-based, less transactional strategy for the agency. But the Intel announcement of a site barely a three-hour drive from Indianapolis still sparked some questions about the state's competitiveness for advanced industry 'megadeals.' The news did seem to influence some parts of SB361, a wide-ranging economic development bill:

- It authorizes new film production incentives, adjusts the terms of existing tax breaks, and limits the total tax credits authorized annually for the IEDC to $300 million (a cap that shouldn't prove overly restrictive, based on current limits placed on individual programs like the Skill Enhancement Fund, Hoosier Business Investment Credit, etc.).
- But outside the $300 million limit, it provides for another $300 million direct appropriation to a flexible business promotion and innovation fund in the next budget cycle.
- Another potential game-changer for large-scale attraction opportunities is the creation of state-led Innovation Development Districts (IDDs) that will capture incremental growth of state income and sales taxes along with local property taxes for physical, financial, and programmatic investments tailored to major projects.
- After much debate over local buy-in and the limits of state-imposed tax increment authority, the bill designates a local IDD fund to capture the property tax increment for use only in the designated district (and a 12% pass-through to surrounding units) to alleviate concerns that local property tax increment could be redirected to other parts of the state as part of an IEDC-controlled fund.
- The final compromise also removed a proposed state-local oversight committee (which fueled disagreement over representation) in favor of directing the IEDC to negotiate terms of the IDDs directly with the executive elected officials of impacted cities and counties for all but the largest deals.
- State sales and income tax increment continues to be dedicated to a statewide fund that can be used across districts and for related purposes (with a $500 million limit in the non-reverting account). The IEDC is authorized to create up to five IDDs (or seek approval from the State Budget Agency), an authority that expires (subject to legislative renewal) in 2025.

During a media availability in Columbus, Intel Executive Vice-President Keyvan Esfarjani summarized the company's reasons for planting its flag in the Buckeye State: "It really comes down to three things: Land, infrastructure and, most importantly, talent," he said. "Ohio meets all of that." (He failed to mention the estimated $2.1 billion in incentives offered by Ohio as a factor.)

SB361 does expand Indiana's ability to make upfront financial commitments and (using IDDs) target resources to land acquisition and infrastructure improvements, two of Intel's stated priorities. As for talent, next year's budget session will reveal the state's commitment to human capital through appropriations to K-12, institutions of higher education (which have seen state support essentially flatlined since 2020), the continuation of ARPA-funded programs like READI and a focus on issues like public health and housing availability.

Wrapping up:

Of the 177 bills passed by the General Assembly in this non-budget year, a number carry fiscal impact beyond reductions in income taxes and revisions in business incentive. Proposals on public health and safety, education, tourism, housing and community development all make claims on current or future state revenues, though many simply create commitments that must be fulfilled through appropriations next year.

A final proposal worth mentioning with potential impact far beyond the FY2024-2025 biennium is HB1004. Today, two-thirds of Indiana's county jails face chronic overcrowding and local taxpayers spend 50% more per capita on them than the 50-state average, according to a recent analysis by the Vera Institute of Justice.

The bill reverses some 2015 criminal justice reforms that ultimately drove this correctional fiscal crisis by assigning those convicted of Level 6 felonies (including non-violent drug offenses) to local detention. HB1004 provides more discretion to remand Level 6 offenders to state prisons, where there are also more treatment programs and re-entry services available for those in need.

The chart on the next page summarizes this and other notable legislation affecting state (and local) finances through the next budget cycle.

Key Legislation (Enrolled & Signed) and Fiscal Impacts from 2022 Indiana General Assembly:

Bill #	Description of Key Provisions	Estimated Fiscal Impact(s)
HB1002	Reduces state income tax rate from 3.23% to 2.9% over seven years, subject to pause if prior-year general fund revenue growth below 2%; repeals utility receipts tax; allows business property taxpayers to select differing valuation methods for certain small-scale steel mill and oil refinery equipment	\$720 million in general fund revenue for FY2023 & FY2024 (3.15% rate); \$469 million in FY2025 **if** CY2025 rate is cut to 3.1%
HB1002	HB1002 also retains current budget provisions transferring excess FY2022 reserves to Pre-96 TRF, but caps the transfer at \$2.5 billion	Net FY2023 revenue loss reduced by \$100 million
	Public Health	
HB1001	Maintains federal enhanced Medicaid & SNAP funding (until April 15); may increase employer UI payments & experience ratings based on provisions ensuring unemployment benefits to employees seeking but not receiving COVID vaccine exemptions (and terminated accordingly)	TBD
HB1193	Changes distribution of Indiana share of national opioid settlement; state share reduced to 50% (vs. 75%) divided among general fund and FSSA-administered treatment/abatement programs) – but could increase total state settlement by increasing local participation, as state allocations based on total population served by participating units	State-level distribution could fall up to \$100 million (further decrease offset by higher total with local opt-in) over time
SB382	Among other provisions, reduces e-cigarette (vape) tax from 25% to 15% of wholesale cartridge price, based on varying interpretations of 'parity' with existing state cigarette tax (99 cents/pack)	Reduce potential general fund revenue \$1.6-2.8 million in FY2023
	Education	
SB2	Broadens enrollment count (ADM) for Fall 2021 to avoid tuition support impact for school districts that were temporarily shifted to remote learning due to the COVID during the traditional ADM count	Potential K-12 expenditure increase of \$2.5 million (FY2022)
	Economic & Community Development	
SB361	Various economic development incentives & programs (see page 4); most fiscal effects confined within \$300 million overall incentive/credit cap, new \$300 million up-front deal-closing fund; impact of state sales & income tax increment for Innovation Development Districts TBD	\$300 million annual cap on IEDC credit/incentives; \$300 million new deal-closing fund (FY2024-25)
SB382	Among other provisions, expands state tax credits for affordable housing development aligned with federal housing incentives	Potential \$2-6 million impact in FY2024, total annual cap at \$30 million
HB1306	Creates a statewide housing taskforce to examine and report on obstacles to affordable and workforce housing development	Undetermined (FY2024-25) based on findings
SB245	Creates a statewide sports and convention bid fund structure (for appropriations in the FY2024-2025 biennium)	Public estimate \$5 million (TBD)
	Public Safety & Corrections	
HB1004	Sentencing flexibility for Level 6 felonies (e.g. non-violent drug offenders) from county jails to state prisons to ease local jail overcrowding and community corrections costs while providing state-level substance abuse and re-entry programming	*(not estimated by LSA)* State expenditures could increase \$40+ million annually, county jail savings could reach \$100 million in 2-3 years
SB7	Creates Marion County Crime Reduction Board and Pilot Project to coordinate efforts among law enforcement agencies and other partners and develop anti-violence strategies in high-crime areas	State and local funding commitments TBD
HB1359	Creates juvenile justice oversight task force and data collection initiative to expand education, mental health and re-entry/transition services in the juvenile justice system (for FY2024-2025 biennium)	>\$500,000 in staffing/ analytical efforts across multiple agencies in 2023