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# FY2020 Close-Out Commentary: When It Rains, It Pours

On July 16th, Indiana OMB Director Cris Johnston and Auditor of State Tera Klutz 'closed the books' on Fiscal Year 2020…and not a moment too soon! It says something about the revenue rollercoaster created by the coronavirus pandemic that a general fund shortfall over $1.4 billion was greeted with muted relief. Indeed, most observers expected the state's balance sheet to look considerably worse.

Exactly four months earlier (March 16th), the first widespread COVID-related restrictions were announced to combat the spread of the voracious virus. At that point, revenues were running more than $100 million ahead of even the more upbeat December forecast – but as Hoosiers hunkered down to flatten the curve, it became obvious the shape of Indiana's finances would change radically too.

Given plummeting tax collections over the last quarter of FY2020, closing the year with annual K-12 appropriations intact and a state surplus still hovering around $1.42 billion showed sound management through an unprecedented crisis. But with Indiana's re-opening plan paused and the future uncertain, many tough choices still lie ahead as we pass the mid-point of the 2020-21 budget cycle.

Let's take a closer look at the numbers (all of the state-issued documents can be found here):

## FY2020 Summary:

- After eight months of strong revenue growth (continuing the trajectory set in 2019), the COVID economic shutdown had a sharp impact on revenues while the public health crisis simultaneously brought new costs as state and local governments mobilized to protect Hoosiers;
- State revenues finished nearly **$1.42 billion** (-8.4%) below the (December 2019) forecast of **$16.79 billion**, with major revenue sources declining across the board – most dramatically in April, as individual income taxes were $669 million below projections, primarily as a result of the extended filing deadline (from April 15th to July 15th, creating consequences described in more detail later);
- FY2020 expenditures were planned at **$16.94 billion** (appropriated in the budget, not counting certain non-recurring appropriations that pushed the total above $17 billion);
- In late May, Governor Holcomb ordered state agencies to implement 15% budget cuts, with the exceptions of K-12, higher education (later directed to absorb a 7% reduction) and the Department of Child Services (DCS);
- These agency reversions and a pause in some planned capital spending – including reversing HEA1007, which shifted nearly $300 million from state reserves to university projects – narrowed the budget gap, but dipping into the surplus was inevitable: Indiana closed the year with **$1.419 billion** in fund balances, down nearly $900 million from its peak after FY2019's close-out;
- Notably, this still represented a surplus equal to more than 8% of annual expenditures – **consistent with 50-state average levels even pre-COVID.** *(FY2019 – National Association of State Budget Officers)*

## More like a Monsoon…Indiana's Rainy Day Protection:

Indiana ended FY2019 with a $2.3 billion surplus, driven by the most robust state revenue growth since 2012. It had taken nearly a decade to build the state reserves to this level (with peaks and valleys along the way) since 2010, when they'd dipped below a billion dollars in the depth of the Great Recession.

It was a degree of fiscal security that policymakers and taxpayers could take comfort in…though the growing surplus began to provoke a backlash on behalf of other budget priorities (i.e. teacher compensation) and debate over the appropriate size of the state's 'umbrella' against a stormy economy.

After all, the state had collected roughly $267 million above the FY2019 revenue forecast as the surplus swelled to 14% of annual expenditures. When July-December revenues finished another $213 million above the FY2020 budget plan, there was broad consensus among Governor Holcomb and lawmakers that a portion of the surplus should be spent in the 2020 session – but how much, and on what?

The General Assembly moved quickly to allocate nearly $300 million to university capital projects (HB1007), agreeing with the Governor on the principle that surplus funds should be used for non-recurring expenses and heading off calls to re-open the biennial budget to boost K-12 expenditures.

Then the global pandemic intruded on Indiana's parochial policy debates. On March 6th, Indiana confirmed its first case of COVID-19. The following week, the General Assembly adjourned, and by late March much of the state's economy had been idled in an effort to control the spread of the disease.

This isn't the place to review or relitigate the years of taxing and spending decisions that grew and preserved Indiana's 'rainy day' funds – it's clear that it helped shelter the state (and protect K-12 appropriations) against the worst of the COVID monsoon. Ultimately, the close-out showed:

- The reversal of HB1007, announced early during the COVID crisis, kept $291 million in the surplus which was then diverted to address revenue shortfalls;
- Another $577 million was moved out of the Medicaid Reserve Account, along with roughly $20 million in interest from the Rainy Day Fund and Tuition Reserve Fund;
- In total, drawing down state reserve funds to $1.4 billion to address a significant share of the FY2020 revenue shortfall – but not all of it.

## Other Adjustments:

- Reversions from 2020 budgeted spending hit $373 million, ultimately approaching $450 million when prior-year reversions (from capital, Medicaid and other reconciliations) totaling more than $75 million were included;
- A $13.2 million transfer was made from the Special Transportation Flexibility Fund – clawing back a portion of the gas tax revenues that are gradually being shifted from the general fund to dedicated road and highway purposes as part of the long-term infrastructure plan passed in 2017;
- On the other side of the ledger, $34 million was shifted to meet an augmented budget request from the Department of Child Services;
- All of these transfers, reversions, deferred projects and curtailed plans represented an "all hands on deck" effort to plug a revenue gap that was growing wider by the day…

## The COVID Cliff:

The decline in revenue over the last three-and-a-half months of the year resembles a cliff – a precipitous drop in tax collections in tandem with negative GDP, soaring unemployment and crumbling consumer spending. Increasing COVID restrictions over the last two weeks of March made a $70 million dent in monthly revenues – followed by a truly calamitous April:

- April revenues were nearly a billion dollars below forecasts, driven by individual income taxes finishing $669 million below projections – however, roughly 80% of this gap was attributed to the tax deadline extension to July 15th, giving Hoosiers until after the end of the fiscal year (June 30th) to file their income tax returns and make year-end payments;
- May revenues followed up with a $233 million – or 20% – deficit to the monthly forecast, with individual income taxes bouncing back to $63 million below the monthly forecast (16% - though the gap would have been closer to 20% if not for more tax returns filed in May than the typical year with an April 15th tax day);
- Sales taxes – Indiana's biggest revenue source, accounting for about 49% of the general fund – were $205.5 million off expectations for April and May combined (nearly 15% below forecasts each month) as households were hit with declining income to spend and fewer places to spend it;
- Thankfully, sales taxes then rebounded in June, finishing nearly even with forecasts (just $4.3 million below a projected $700.5 million month) as Indiana gradually loosened some business and social distancing protocols – the year-end gap was $163 million, only 2% under forecasts due to solid pre-COVID collections;
- Amid this re-opening, June did feature the smallest gap versus forecast (-12.4%) of any month since March, though the dollar amount of the loss ($253 million) was larger than May;
- Gaming revenues also began trickling back into the coffers in June, as riverboats and racinos collected $13 million – 75% below their original forecast, but up from zero in April and May as these facilities were ordered closed in March;
- Corporate taxes were substantially below forecasts starting in March as well, with an even bigger shortfall in April (as with individual income) and a $184 million (-21%) deficit for the year.

## Tax Day Tradeoff:

Declines in nearly every state revenue stream added up to the total $1.42 billion underperformance versus the December revenue forecast, or $1.29 billion against the more conservative budget plan. (Interestingly, alcoholic beverage revenue finished up 1.6%; I'll avoid the obvious editorial comment about circumstances demanding a drink.)

State budget officials managed spending against this daunting gap – but ended the year with the 'true' shortfall still in question, as the extended tax filing period continues to complicate the fiscal outlook.

Well over half ($800 million+) of the total revenue deficit could still be attributed to individuals and employers taking advantage of the July 15th deadline. Facing historic levels of economic hardship, however, it's also difficult to predict how many delayed payments will become delinquent – so while the first month or two of FY2021 will benefit from this backlog of returns, it's unclear whether the state will collect a high percentage of 2020's individual and corporate income taxes that remain on the books.

## Looking Ahead: Issues & Implications for 2021

So FY2020 ends with a major question mark (income taxes filed from late June through July 15th) extending into 2021 – and that's far from the only uncertainty that greets state budget and agency officials in the New (Fiscal) Year. To mention just a few critical issues that loom ahead:

**THE SHAPE OF THE CURVE:** Indiana faces three crises – public health, economic, and fiscal – and the resolution of the first will largely determine the severity of the other two. At this writing, COVID cases are on an upward trend and Governor Holcomb has announced a statewide mask order in response: Will trends allow Indiana to stay at 'Stage 4.5,' maintaining a level of economic activity (and therefore tax collections) to follow? Is Stage 5 on the horizon before the end of summer?

**THE SHAPE OF THE RECOVERY:** Whether the virus is resurgent or in retreat will also influence the depth of the 'COVID recession.' But regardless, we face a long climb back to normalcy; will this downturn be followed by a V-shaped recovery (sharp decline, quick recovery), a U-shape (more prolonged trough) or a 'swoosh' (picture a Nike logo, with a steep drop-off and more gradual rebound)? Economists from Moody's predict that state revenues may not return to 2019 levels until FY2023 or 2024.

**THE STABILITY OF SALES TAXES:** Sales taxes have traditionally offered stability during economic turmoil. Declining earnings are usually followed by a corresponding drop in income tax revenue. But even after a household is hit by layoffs or pay cuts, spending continues at a certain pace as consumers shift priorities, tap into savings or add debt to avoid dramatic lifestyle changes until absolutely necessary. Sales tax trends are more modest as a result.

During the fiscal years impacted by the Great Recession (2009 and 2010), for example, Indiana sales taxes fell below forecasts by a total of 3.6%, while income tax revenue dropped by 11%.

The 15% drop in sales taxes in April and May showed the unique pressure of COVID-19 restrictions put on consumers and businesses that generate taxable sales, as social distancing leaves the average household with less money to spend and fewer places to spend it. The June rebound in sales taxes is a comforting sign, but is it a sustainable trend or a blip of pent-up demand as eager consumers greet re-opening? And how would a prolonged pause (or a second wave) affect Indiana's largest source of revenue?

**BALANCED BUDGET AMENDMENT:** Consumer sentiment and sales taxes will be among the many variables facing the Revenue Forecasting Technical Committee as they update the state's FY2021 projections this summer. Looking towards the next budget cycle, FY2022-23, their work will take on even greater urgency for legislators: Given the mechanisms described in the state balanced budget amendment passed in 2018, will 2020-21 shortfalls cause deductions to the forecasted revenues available for the next budget plan?

**FEDERAL AID:** Certainly the additional unemployment benefits ($600/week) subsidized by the federal government has helped prop up state personal income (which grew 1.2% in Q1, led by public transfer payments) and consumer spending. Will Congress and the Trump administration reach a deal to extend these benefits? Will future stimulus include more aid to state and local governments, and will it allow for revenue replacement?

On a related note, how will the state deploy remaining CARES Act funding in FY2021? Resources from the Education Stabilization Fund are already flowing to K-12 school corporations and post-secondary institutions, with limits (and some controversy) on how they can be used. Indications are that Indiana is been cautious in allocating other funding, hoping that future federal guidance brings more flexibility.

‘Caution’ is a good word to reframe FY2020 in closing: Indiana has earned ‘AAA’ marks by the major rating agencies for good reason, having built the $2.3 billion surplus that greeted 2020 after a decade of balanced budgets and disciplined spending. Public pensions are also prudently funded; as a percent of state personal income, pension and debt liabilities are well below the 50-state average.

So while few could have predicted the global pandemic that dealt a crushing blow to state and local budgets across the United States, it’s noteworthy that last week’s close-out report was grim but not yet dire. By staying prepared for the inevitable rainy day, Indiana has managed to stay afloat in these unprecedented fiscal floodwaters.