Indiana Revenue Forecast, December 2016

Information Brief

By John Ketzenberger

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Summary

Indiana's tax revenue is expected to be significantly less ($300 million) than what was forecast a year ago, dampening the outlook for new spending in the next two-year budget lawmakers will begin formulating in January.

The culprits: lower-than-expected gasoline prices and corporate income tax collections.

The revenue forecast committee made changes to the formulas for the sales tax on gasoline, which they expect will yield more reliable predictions. A revised forecast is due in April that lawmakers will use as they complete their budget deliberations.

One caveat: the forecasting process was complicated by the presidential election this year since it is unclear how the incoming Trump administration will affect federal policies or how quickly it will act.

Introduction

Indiana uses a two-pronged approach to estimating how much tax revenue will be available for lawmakers to appropriate in the coming legislative session. It's a rare and particularly effective bi-partisan exercise that eliminates arguments over available revenue, instead focusing discussions on appropriations.

The first step is an economic outlook for Indiana, which is delivered by a non-partisan third-party, IHS Markit. The second step is the actual revenue forecast, conducted by a bi-partisan committee of experts who use the economic forecast as the basis for determining how much tax revenue the state should expect over the next two years.

Economic Outlook

Indiana's economy, as measured by real gross state product, is expected to grow 1.9 percent in 2017 and 2.3 percent in 2018, according to IHS Markit's forecast. The economy expanded 1.7 percent in the current year and just 1.4 percent in 2015.

The modest increases forecast for the next two years could be seen as an extension of the extremely slow growth out of the last recession in 2008-09, and they are scaled back from previous years' estimates. The forecast detects a shift in the employment data, however, that should benefit the state.

The employment market should begin to favor employees. Payroll employment growth is expected to decrease to less than 1 percent in each of the next two years, but wage income is expected to jump 4.4 percent next year and 5.1 percent in 2018. It's a sign that employees will start to benefit from productivity gains with employers willing to pay more for their work.

One worry: an extension of the reduction in net manufacturing jobs in Indiana that started in 2015. The economic forecast predicts the decline will moderate, but it will still mean the loss of higher-wage jobs. Most of the job growth since October 2015 was in health care and in several service-related industries. The three-year outlook in the economic forecast expected health care to remain strong, but the business and professional services sector should provide the bulk of nearly 88,000 net new jobs expected through June 2019.

While the jobs numbers bolster recent tax collections from the state's second-largest source of revenue—individual income taxes—the economic forecast also raised hopes that the largest source by far, sales taxes, would recover. Housing starts are expected to rise 8.4 percent next year and 6.3 percent in 2018.

In addition, the forecast anticipates personal consumption to increase by 4.7 percent next year, up from 3.6 percent this year. The forecast expects a healthy 4.5 percent increase in 2018. Still, people are spending an increasing portion of their money on untaxed services instead of durable and non-durable goods subject to the sales tax.

Indiana's challenge remains to retrain portions of its workforce affected by manufacturing cutbacks while fostering continued growth and innovation in the high-tech sectors.

Tax revenue forecast

In non-budget years Indiana conducts just one economic forecast. Given the state's economic performance and the tax revenue derived from it, the forecast released today revises Indiana's revenue expectations downward by 2 percent, or $299.9 million. This essentially resets the revenue base from which the new two-year budget will formulated to slightly more than $15 billion.

It also means in the current fiscal year, which ends June 30, the budget will outspend projected revenue by $378 million. Any actual shortfall will be determined when the books are closed on Fiscal 2017 next July, but the state has adequate time to address any budget-related moves to reduce costs and there are adequate reserves if necessary.

The revenue forecast committee does expect Indiana's economy to generate slightly more than $1 billion in new revenue during the next two-year budget cycle. The forecast includes 2.9 percent growth, or $437.3 million, in FY2018 vs. the current fiscal year, 2017. It expects revenue to increase 3.9 percent, or $606.2 million, in FY2019.

The state has two major sources of tax revenue—sales and individual income. The revenue forecast revised down sales tax collections by 3.5 percent in FY2017, for a new total of $7.4 billion. It revised up the revenue from individual income tax collections by one-half point to $5.4 billion. The remaining major sources of revenue—corporate income and gambling taxes—were revised downward.

The forecast anticipates steady growth in all areas except gambling, which is expected to decline from $407.4 million in FY2017 to $391.4 million in FY2019.

Legislative outlook

Fiscal leaders in the General Assembly spent the weeks since the election diminishing expectations ahead of the revenue forecast, which proved prescient. They recognize that while revenue is expected to increase by $1 billion over the biennium, the needs and wants of Hoosiers will be hard to meet.

It's less likely there will be any new efforts to reduce taxes in Indiana. If so, it would be the first budget year since at least 2007 without some form of tax reduction. It's more likely legislators will increase the gasoline tax and index it to the consumer price index or another economic indicator to pay for an aggressive transportation enhancement program. Other means to generate revenue, such as tolling on interstates or issuing bonds for projects, are likely to get serious consideration.

The Medicaid forecast, issued at the beginning of today's State Budget Committee meeting, offered some mixed news. Costs are less than expected by about $387 million. If this trend remains it will relieve some budgetary pressures in other areas such as education spending. The costs are expected to increase about 8 percent in FY2018 and about 6 percent in FY2019.

It's less likely there will spending on new programs such as pre-kindergarten, and more emphasis placed on adjusting the existing school formula. It's not yet clear whether that will mean more money for teacher salaries or other areas of the formula.

The State Budget Committee was expected to finish its preliminary hearings this week. Gov.-Elect Eric Holcomb is expected to reveal his budget priorities on Jan. 5 and the House is expected to unveil its budget proposal about the same time. A new budget is expected before the session ends April 30.

Conclusion

The sluggish economy failed to meet economic growth projections in Indiana, in turn forcing revenue forecasters to revise down expected tax collections by $300 million. While the economy is expected to grow over the next two years producing about $1 billion more in tax revenue, it will be a challenge to meet spending expectations for transportation and education on top of inflation. Lawmakers likely will remain prudent in appropriating new general tax revenue and probably will look to alternative sources such as higher sales taxes, tolling or bonding to bolster new transportation spending.

About the author

John Ketzenberger is president of the Indiana Fiscal Policy Institute. Ketzenberger has studied and written about Indiana's budgets since 1991.