INDIANA FISCAL POLICY INSTITUTE
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Policy Brief: Local Government Fiscal Trends & Future Sustainability

Will recession's rainy day put local government underwater?

In many ways, Indiana is one of the better-insulated state governments against the fiscal threat of recession. According to a recent analysis from the Pew Charitable Trust, Indiana is among just a handful of states with unfunded liabilities representing less than 10% of total personal income and the ability to sustain government operations more than a month using only 'rainy day' fund balances.

However, the local view – from county and municipal units most notably – is quite different. Decades of policy decisions have limited local revenues and exposed local finances to greater economic volatility. Since the 1970s, local government units in Indiana have generally been more frugal (by expenditures per capita) than their national peers; since property tax caps were enacted in 2008, this gap has widened significantly.

Since tax caps have been in effect largely during the recovery from the Great Recession, we don't know the consequences of a future downturn on the fiscal health of local government. **At more than ten years after the financial crisis, and with three in four national economists predicting a recession before the end of 2021** [National Association for Business Economics, 2019]**, it's a question that demands attention.**

"A Fiscal History of Indiana Local Government"

The last forty years have seen a dramatic – even seismic – shift in local government finance in Indiana. From the 'Bowen tax package' of the mid-70s to the last decade's property tax cap era, there's been an inexorable shift away from property taxes as the primary source of local government revenue, with state government assuming a greater role in areas like public education and welfare via sales taxes, and local income taxes becoming a critical source of county and municipal revenue.

In 2017, the Indiana Fiscal Policy Institute initiated a research project to quantify how these policy changes have impacted local budgets, expenditure priorities and revenue sustainability.

The result is a report from Professors Craig Johnson and Justin Ross of Indiana University's School of Public & Environmental Affairs, "A Fiscal History of Indiana Local Government." While the report offers a data-driven retrospective of the sweeping changes noted above, it also provides valuable context to debate the future sustainability of the current revenue system. To summarize:

The last forty years of Indiana fiscal policy has shifted the local tax base away from property tax revenue and towards local option income taxes (and state sales taxes supporting education & welfare).

The most dramatic change – property tax caps – has contributed to revenue constraints and uncertainty (chronic deficit risks from cap losses) unique in 'modern' fiscal history.

Local governments are spending at 2002 levels, have retrenched even more on capital investments, and are keeping larger surpluses – cautious about long-term commitments.

But operating this way during a recovery with strong employment, and more dependent than ever on income taxes (which rise and fall with the economy), can local governments adapt further to weather a downturn?

Taking a closer look at some of the key findings:

Revenue & Spending Trends:

- Since 1973, Indiana tax policy has gradually limited local property taxes, exchanging lost revenues with state sales taxes and local income taxes; major tax restructurings in 2002 (in response to the St. John 'market value' decision) and 2008 (property tax caps) accelerated this trend;
- Overall, local (per capita) property tax revenues have dropped roughly 40% since a peak in 2005;
- Local income taxes now represent more than 15% of local government revenue, with much greater volatility – there have been major income tax revenue drops in 2002, 2010 and 2011; after local income taxes tripled from 2004-2010, they dropped more than 30% from 2010-2015;
- From the late 1970s to 2005, total local revenues in Indiana have risen on a (relatively) steady, upward trajectory, from roughly $12 billion in 1980 to approaching $30 billion in 2005; 2005-2015 represents the first decade in this span where revenues have finished below where they started;
- Budgeting has tightened in respond to revenue constraints and volatility: While Indiana local government generally spent less per capita than the average of U.S. localities (per Census data) over the last forty years, the gap has widened considerably since the mid-2000s;
- Recently, local governments nationwide have been rebounding from a 2009-12 period of belt-tightening while Indiana continued to decline; in 2015, U.S. per capita expenditures had climbed back to where they'd been in 2010, while Indiana's local spending had dropped to 2002 levels;

Budget Priorities & Challenges:

- The way local governments are spending has also changed: Capital spending per capita has fallen by a third over the last thirty years, from 15 cents per dollar of operating expenditures to 10 cents (since 2009);
- As the state has taken on the operational funding of K-12 education and county welfare, the dominant categories of local government budgets have become public safety, county hospitals and other public health programs, and debt service;
- While some more sweeping proposals to restructure local government have fallen short in the Indiana General Assembly, there has been consolidation to grapple with declining revenues – from 2007-2012, Indiana shed more than 500 governmental districts (bucking the national trend of creating more special districts);
- Local governments have also been keeping larger surpluses since 2007, to address likely property tax cap 'circuit breaker' shortfalls and reflect more cautious approach towards long-term commitments as revenues generally decline;
- In short, local budgeting and fiscal management seem to have become increasingly 'lean' (in contrast to national trends); while the authors don't make judgements on the impact of these moves, they question their sustainability if revenues fall – and demand for public services stay constant or increase – during an economic downturn or recession.