INDIANA FISCAL POLICY INSTITUTE
SINCE 1987

November 15, 2021
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Study of Indiana local income taxes finds $750 million held in state reserves; rule changes could reduce balances by $200+ million to boost local budgets

(INDIANAPOLIS, Ind.) The Indiana Fiscal Policy Institute (IFPI) has released a new report on Indiana's local income tax (LIT) structure by Dr. Larry DeBoer of Purdue University. Hoosiers pay state and local income taxes together: State revenue is immediately available for the current budget, but the local share is deposited in state-level accounts and distributed back to counties based on past collections. **Dr. DeBoer finds that rules designed to protect these accounts from recession shortfalls could be relaxed to release $200+ million in surplus balances to local governments and reduce the gap between future collections and distributions.**

Certified LIT distributions are based on tax payments over the previous state budget year (July through June). This means nearly two years between incomes being earned, taxes filed, and LIT distributions made to local governments. The State of Indiana manages the process through 92 county LIT accounts, akin to checking accounts with current tax collections as deposits and certified distributions as withdrawals. Balances build in these accounts when collections outpace distributions during the delay built into the system.

"Income taxes have nearly caught up with property taxes as share of non-school local revenue to support police and fire protection, jails, infrastructure and other priorities," noted IFPI president Chris Watts. "COVID's disruption of income growth prompted Dr. DeBoer to look at the state's administration of LIT account balances over the last twenty years, especially the new rules put in place after the last recession."

When taxable income grows and collections are consistently higher than distributions during economic expansion, account balances grow and are periodically reduced with special distributions. Dr. DeBoer explained that state law requires a minimum balance above 15% of annual distributions to protect against recessions, when taxable income declines and collections can drop below distributions.

"After the Great Recession, 59 counties ended 2010 with negative LIT balances," DeBoer said. "The state had to cover the losses and freeze distributions until collections caught up and eventually settled on the 15% balance reserve as a precaution against the next economic crisis. After a decade of growth and expansion of LIT interrupted by the COVID recession, it's time to ask how well this 15% limit is working.

"COVID caused a steep economic recession that was also remarkably brief, and its impact on revenues seems short-lived as well," DeBoer continued. "But even against the threat of a deeper recession, we can say that the 15% balance requirement on county LIT accounts works as intended – but perhaps it works too well."

Actual balances in county accounts approached $950 million in 2020, over 33% of annual distributions, highlighting the challenge of managing the delays between collections and distributions.

"This analysis focuses on the tension between reducing the risk of negative LIT balances versus letting unused balances grow too large," DeBoer added. "We've created a nearly recession-proof system but limited local revenues in the process. Each percentage point in required balances equals roughly $50-60 million not available for the services these taxes were collected to support across the state."

DeBoer's conclusions in **Indiana's Local Income Tax: Distributions and Balances in Recession and Expansion**:

- During periods of extended income growth, the current system doesn't allow balances to be limited to 15% in "real time," as evidenced by 2020 reserves more than double the statutory requirement.

- While the state uses special LIT distributions to reduce excess balances, these calculations are also based on prior-year reports of collections and certified distributions, so total distributions never catch up with collections as long as taxable income grows (and accumulating interest adds to year-end balances).
- The timing of special distributions also makes local budget planning more difficult, as local officials can only anticipate certified distributions in advance of the budget year.
- The COVID pandemic did slightly reduce taxable income, but the dip in collections will not threaten total balances or any individual county accounts – DeBoer's analysis estimates that balances across all 92 counties will decrease to roughly $750 million (still 25% of total distributions) by the end of 2021.

Certified LIT distributions for 2022 are expected to decline just $50 million statewide (out of a base of nearly $3 billion) partially attributed to a shorter timeframe for processing tax returns after delayed filing deadlines in 2020 and 2021. To get a better idea of how county account balances and the 15% rule would withstand a more severe recession, Dr. DeBoer created 'stress tests' based on steeper declines in statewide taxable income and **lowering the balance limit below 15%** to release more revenue to local governments:

- If 2020's turmoil had deepened into another Great Recession (a 6.5% annualized drop in taxable income), just one county LIT account would have turned negative, with 20%+ total balances at the end of 2021.
- Account balances in 2021 (with the 15% limit) could have withstood a near-depression level downturn (a 10% decline in taxable income) with two counties showing negative balances and 14% total balances.
- **If the balance reserve was reduced to 12%,** the Great Recession scenario would still have left 15% statewide balances at the end of 2021, with just two counties dipping into negative balances.
- **If the balance reserve was reduced to 11%,** another Great Recession would have forced three counties into negative balances with 13% total balances remaining across all 92 LIT accounts.
- **In even the most severe recession** (a 10% decline in annual taxable income), reducing the balance limit to 11-12% would maintain total balances above 10% statewide with only 4-6 out of 92 counties dealing with negative accounts.

Reducing the balance requirement in county LIT accounts to 11-12% would release roughly $200 million from current balances for special distributions to counties. The change would also adjust the future calculation of certified distributions, bringing them closer to the underlying base of taxable income.

"A third principle for the local income tax system is predictability for local governments," DeBoer finished. "Balances will continue to grow when collections outpace distributions, but a lower balance requirement lessens the need for special LIT distributions made outside the regular budget process."

The full report, "Indiana's Local Income Tax: Distributions and Balances in Recession and Expansion," can be downloaded **here** at www.IndianaFiscal.org, along with twenty years of county-by-county data on local income tax collections, distributions and account balances in spreadsheet form.

About the Indiana Fiscal Policy Institute:

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