A Fiscal History of Indiana Local Government

A research report for the Indiana Fiscal Policy Institute

by

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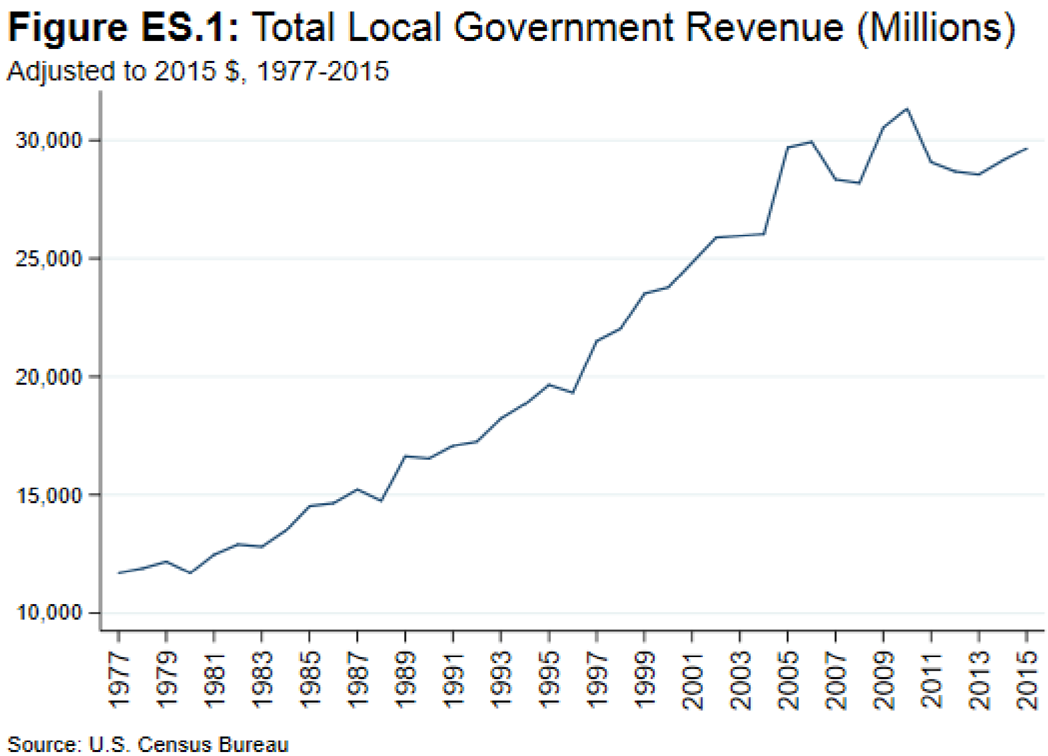
Executive Summary

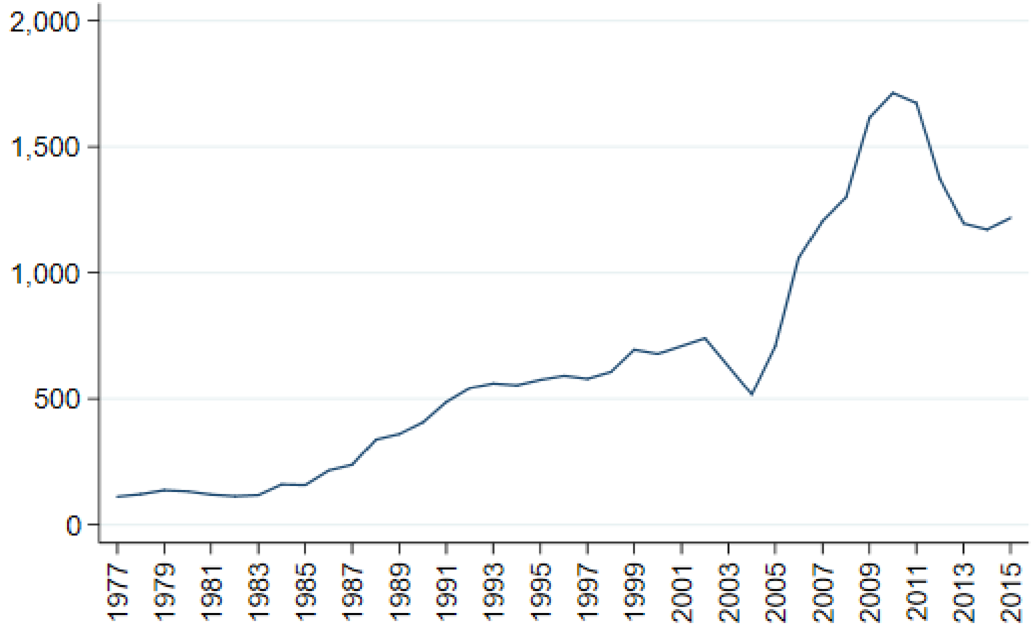
Over the last 40 years the fiscal structure of Indiana's local governmental units has showed remarkable consistency up until the early 2000's. On the revenue side much of the recent changes are fully consistent with the foundation laid by the Bowen tax package in 1973 - property tax relief; an expansion of local government authority to generate revenue from local income taxes; and an increase in the state sales tax to fund local services, programs and provide additional property tax relief.

A structural shift in real own-source local government revenue began in 2004, as shown in Figure ES.1. Local income tax revenues took off and did not stop increasing until 2010. Property tax revenues showed unprecedented growth from 2004-05, but have since showed a dramatic total decline. The growth of the local income tax, with its inherent volatility, coupled with the decline and increasing instability of the property tax from both economic and policy factors, have resulted in a less stable revenue structure for local governments (Figures ES.2 and ES.3).



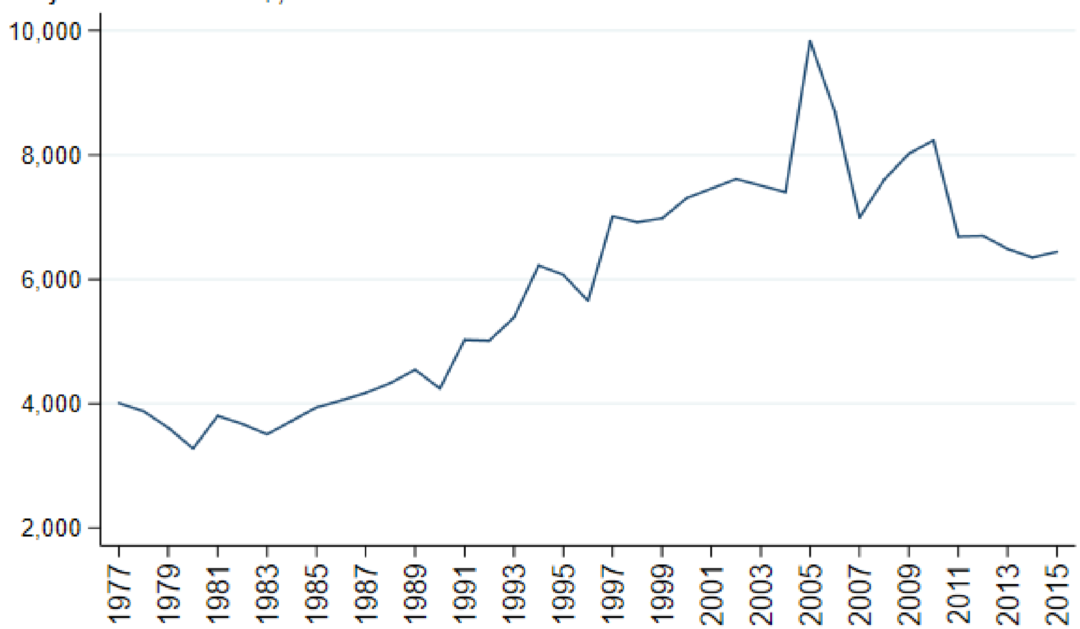
Indiana local income tax and property tax revenues have yet to recover from steep declines following the Great Recession. Both taxes have declined sharply since 2010. In 2015 real property taxes in Indiana are back to where they were in 1996-97, while real 2015 income tax revenues have returned to their 2007 level. Given the real decrease in local income and property tax revenue, local public expenditures in Indiana are now being funded from a substantially smaller pie of local own-source revenues.

Figure ES.2: Total Local Income Tax Revenues (Millions)
Adjusted to 2015 $, 1977-2015



Source: U.S. Census Bureau

Figure ES.3: Total Property Taxes (Millions)
Adjusted to 2015 $, 1977-2015



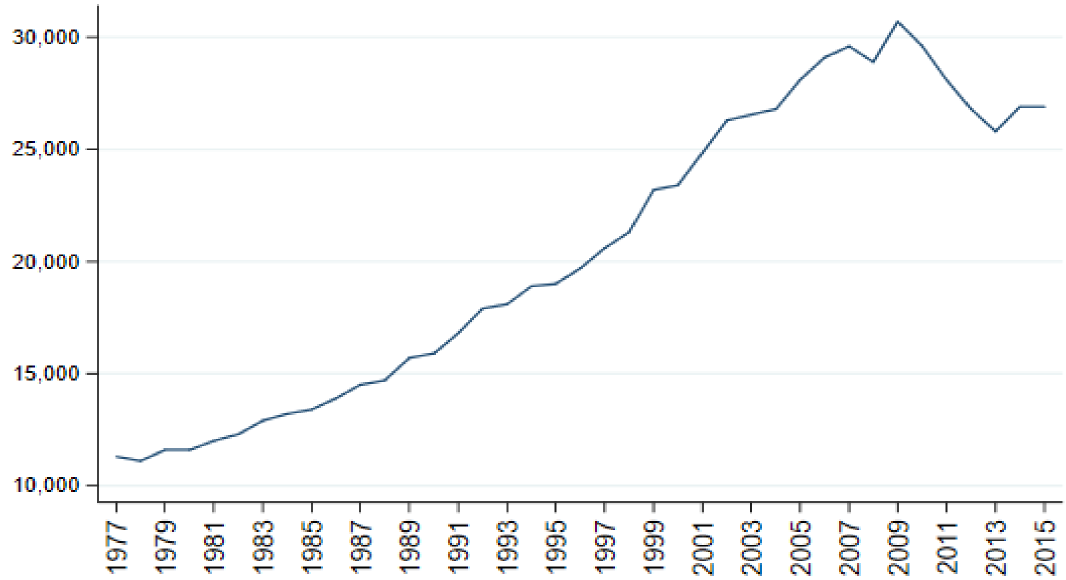
Source: U.S. Census Bureau

The last 40 years of local government expenditures should be viewed as "before and after 2009." Since 2009, Indiana has undertaken an exceptional decline in local public expenditures, as shown in Figure ES.4. For four consecutive years Indiana's local governments cutback expenditures on average by more than 3.5% in each year in real terms. A significant amount of the decrease in Indiana county expenditures comes from the release of welfare administration functions as part of House Enrolled Act 1001 (2008). The state sales tax rate rose from 2 percent in 1973 to where it stands now at 7 percent in order for the state to take over several local general government and school corporation funding responsibilities, and provide property tax relief. A portion of the reduction in local public expenditures from 2007-2012 likely comes from local government consolidation in Indiana where on net 520 independent local governmental units have been shed.

In Indiana the rapid decline in local public expenditures is related to the trend in local government employment. The number of local government employees in Indiana reached its peak in 2008, slightly declined in 2009 and substantively declined through 2012 (Figure ES.5). Nationwide local government employment has begun to rebound while remaining basically flat within Indiana. About 70 percent of the net employment losses in Indiana local government employment have come from education services.

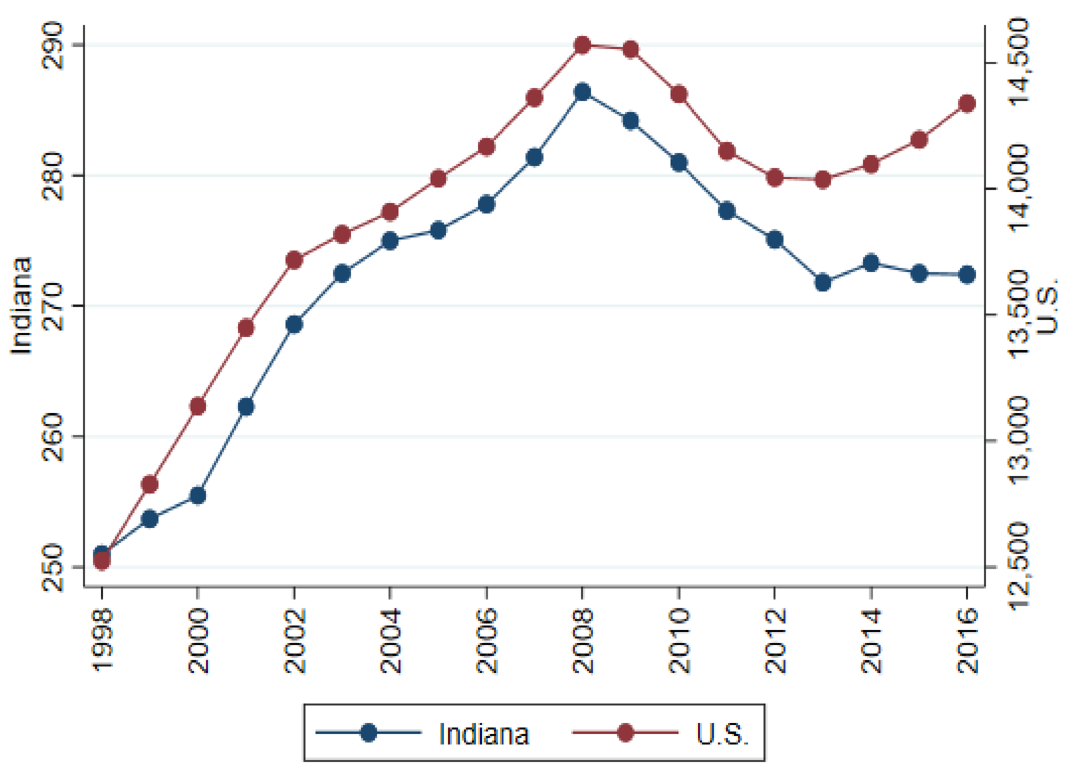
Indiana's local fiscal structure has demonstrated sustainability partially because the loss of own source revenues has been made up by increases in state revenues, but mostly because of the substantial reduction in local public expenditures. The structural changes in revenues and responsibilities across Indiana's state-local sector over the last fourteen years, coupled with real reductions in own-source local revenues, represents a fundamental transformation of Indiana's intergovernmental fiscal system.

Figure ES.4: Total Expenditures (Millions)
Adjusted to 2015 $,1977-2015



Source: U.S. Census Bureau

Figure ES.5: Local Government Employment for Indiana and U.S. (1000s)



Source: U.S. Census Bureau

1. Introduction

This report provides an analysis of the post-1973 fiscal history of Indiana local governmental units. Its focus is at the aggregate level on the revenues available to local governments, especially own-source revenues, and the expenditures financed by those revenues. It traces the public policies that have shaped the fiscal history of Indiana local governments from 1973 to the present era, and infers implications for fiscal sustainability across the Indiana local government finance structure.

The state has undertaken major reforms of the tax system for local governments several times since 1973.[1] Today, the two primary sources of own source local revenue in Indiana are from taxes on income and property. The property tax has always been the primary source of tax revenue for local governments as a percentage of total revenue, but on a real (adjusted for inflation) basis the property tax has been in steady decline since 2005. The income tax, on the other hand, has grown significantly since the first local option income tax was created in 1973. Local income taxes are now a significant portion of local taxes and an important component of total local government revenue in Indiana. The growth in local income taxes, however, has not offset losses in property tax revenue in recent years and overall these two taxes as a share of total local revenue is down. In addition, the growing amount and share of local income taxes has made local revenues more volatile since 2004.

The increased volatility and diminished reliance on property taxation can be traced in large part to changes in the property tax system after the 1998 Indiana Supreme Court ruling in *Town of St. John v. State Board of Tax Commissioners*. Since that decision, the property tax assessment system has been administratively restructured and the assessment system has been

[1] See Appendix 1, Major State of Indiana Policy Reforms of Local Government Fiscal Structure: 1973-2016.

converted from “true tax value” to market value. In determining that the old “true tax” system was in violation of the state constitution’s Property Tax Clause, which requires the property tax assessment system to be uniform and provide an equal rate of assessment and taxation, the court not only overturned the old assessment system, but it sent into motion changes throughout the entire system of Indiana local government finance. Throughout all the major post-*Town of St. John* fiscal reforms, including major legislative changes in 2002, 2007, 2008, 2010 and 2015, the basic nature of the changes made by the state to the local governmental finance system has been remarkably consistent: an emphasis on property tax relief; an expansion of local government authority to generate revenue from local income taxes; and an increase in the state sales tax to fund local services, programs and property tax relief.

The expenditure side of the Indiana local fiscal structure demonstrates adaptation to these new realities. Total expenditures on local government services increased consistently from 1980 to 2009. Since 2009, Indiana local governments have reduced aggregate real expenditures. This has been accompanied by workforce reductions, eliminations of special districts, reductions in fiscal administration costs, and lower-than-average growth in highways and roads spending. This also reflects that local governments have also been relieved of welfare administration expenses over this period and school corporations now pay for general fund expenditures out of state aid. There is also some rebalancing away from capital projects, perhaps a response to additional political constraints, and less total revenue from a more volatile revenue stream.

This report documents changes and trends in the revenues and expenditures of Indiana’s local governmental units within the context of these policy changes. We continue with a more detailed historical perspective of fiscal policies in the next section: Fiscal Policy Timeline Overview. We then provide a long run analysis of local government own-source revenues followed by a long run analysis of local expenditures in aggregate and across different levels and types of government. We then synthesize our findings on revenues and expenditures to draw inferences in the section on fiscal sustainability and end with the conclusion.

2. Fiscal Policy Timeline Overview

State reforms and policies directed at the current local government finance system have a demonstrated theme. Though property tax limits were first put in place in the 1930's (Stullich, 1990; Bennett and Stullich, 1992; Faulk, 2013), in 1973 the General Assembly passed what is commonly referred to as the "Bowen Tax Package," which restructured taxes in Indiana for decades to come by establishing the political precedent for exchanging local property taxes for local income taxes and state sales taxes. Under this policy, local government revenue from the property tax would be placed under specific controls and limitations and relief would be provided to property taxpayers; to replace forgone property taxes, local governments would be given the option to impose a tax on the local income of taxpayers and the state would also chip in sales tax revenues to provide additional tax relief.

Specifically, in 1973 the state of Indiana increased the state sales tax from 2 percent to 4 percent to finance a Property Tax Replacement Fund which reimbursed local governments for a 20 percent reduction in property taxes. The state also established the first local option income tax - the County Adjusted Gross Income Tax (CAGIT) - and froze property tax levies for counties that adopted CAGIT to encourage property tax replacement, and froze property tax rates altogether for counties that did not adopt CAGIT. (Ryan, 2010) A levy freeze, then as now, is viewed as a more effective tool to reduce property taxes over the long-term.

In the Bowen Tax Package, the figurative deal was stuck between Indiana government and its taxpayers that lasts until this day. Beyond the immediate reduction in property taxes, the state supported long-term local property tax relief by imposing controls on property tax growth, limiting their future growth, and the burden of financing such relief was to be shared by the state sales and local income taxpayers. Some tax relief funds came from the state sales tax, and other relief funds came from local income taxes. The general structure of the local income tax – type of tax, maximum rate, uses of revenue, etc., - was always intended to be under the control of the state government. Such policies not only remain in place, but have been reinforced and expanded by subsequent generations of lawmakers. Since then, Indiana's local tax system has had several important detours along the way, but the essence of the 1973 tax reform package remains today. Indeed, it was strongly reinforced with the change in the state constitution in 2010.

After the 1973 reforms, the legislature made several adjustments to the fiscal system from 1977 to 1989, including constraining the assessed value growth of non-school civil taxing units, removing property tax replacement credits from debt service and capital funds, and passing additional local income taxes. The legislature also enabled school corporations to override maximum levies if approved by voter referendum. These reforms made important changes to the local fiscal system, and laid the foundation on which subsequent reforms in these areas have been based.

A major shock to the property tax system started in 1993 when the initial *St. John v. State Board of Commissioners* case was filed. *St. John* challenged the basic constitutionality of the property tax assessment system, arguing that the "True Tax Value" system was unconstitutional because it violated the "uniform and equal" section of the Property Tax Clause of the Indiana constitution. In 1996 the Indiana Tax Court ruled that the "True Tax Value" system of assessment was unconstitutional and that Article X, section 1 of the state constitution required a system of "real property taxation based solely on fair market value." The case was appealed by the State Board of Tax Commissioners to the Indiana Supreme Court. In December 1996, the Indiana Supreme Court reversed the Tax Court's holding and remanded the case back to the Tax Court to determine whether the True Tax Value system results in a "uniform and equal rate of assessment and a just valuation based on property wealth." On December 22, 1997, the Tax Court upheld that the True Tax Value system violated the Indiana Constitution.

In 1998, the Indiana Supreme Court ruled that the True Tax System of property assessment, as implemented by the State Board of Tax Commissioners violated the tests of uniformity and equality in the Property Tax Clause. The court ruled that property should be assessed "under a system that incorporates an objective reality," but that did not necessarily mean that the system had to be based on market value. The case was again remanded to the Indiana Tax Court, which in turn mandated the State Board of Tax Commissioners change the assessment system to comply with the state Constitution. In 2000, the Tax Court ordered the State Board of Tax Commissioners to "adopt new, constitutional regulations no later than June 1, 2001" and reassess real property under new and constitutional regulations by March 1, 2002. The 2002 Real Property Assessment Manual did not establish "fair market value" as the new assessment standard, but rather modified the definition of true tax value as "the market value-in-use of a property for its current use, as reflected by the utility received by the owner or a similar user, from the property."[2]

[2] *2002 Real Property Assessment Manual*. Downloaded from Indiana Department of Local Government (DLGF) website on January 9, 2018.

The *St. John* decision set forth changes that reverberate to this day, not only in property assessment, but throughout the Indiana public finance system. While the State Board of Tax Commissioners was defending its assessment system in court from 1993-2000, the General Assembly had been working along a separate track to understand the implications of a potential *St. John* final decision that required a change to market value, reform laws governing the property assessment system to comply with such a final determination, and make changes in other areas of the intergovernmental finance system as appropriate. Research studies sponsored by the General Assembly, in conjunction with the State Board of Tax Commissioners, found that converting Indiana's property assessment system to market value would have wide ranging impacts on Indiana taxpayers, causing property tax bills to increase substantially for several groups of taxpayers.[3]

In response, the General Assembly called a special session in 2002 to address problems arising from these shifts in property tax burdens. The legislature passed Public Law (P.L.) 192 which was intended to lessen the impact on taxpayers from expected increases in assessed values from the conversion to a market value system. P.L 192 implemented property tax relief by increasing the standard homestead exemption from $6,000 to $35,000 and effectively eliminating the business inventory tax; it financed property tax relief with an increase in the state sales tax from five percent to six percent and enabling counties to levy a County Economic Development Income Tax (CEDIT). The property tax relief was timed to coincide with the general reassessment of 2002 (pay 2003). But it did not have the full intended effect of smoothing over

[3] See Deboer, Larry, David Good, Craig Johnson, Joyce Man. Report of the "Indiana Fair Market Value Study" presented to the Indiana Study Committee on Real Property Assessment Practices. Indiana General Assembly. State Board of Tax Commissioners. December 10, 1996.

changes to the market value system for all taxpayers. When many taxpayers received their 2003 pay bills they were incensed at the increase.

After the new assessment system had been in place for few years, some politically influential taxpayer groups asserted that their property tax bills had steadily and significantly increased for several years now. They publicly rallied against the increases and helped influence an entire package of fiscal policy reforms proposed by Governor Daniels and passed by the General Assembly in 2008 in HEA 1001.

HEA 1001 called for a massive transfer of local responsibilities to the state government. The state government increased the sales tax from six percent to seven percent, used existing gaming taxes,[4] eliminated property tax replacement credits, and redirected a portion of existing sales tax revenues previously used to subsidize local spending to: 1) finance the elimination of local school tuition support levies, increasing state participation in K-12 schools; and 2) assume financial responsibility for several local government programs previously financed by local property taxes, including child welfare, juvenile incarceration in state facilities, state fair and forestry, health care for indigents, pre-school special education, and police and fire pensions.

HEA 1001 also created Public Question 1 which proposed property tax caps expressed as a percentage of gross assessed valuation on various classes of property beginning in 2010. Effectively, Public Question 1 proposed that a property taxpayer's cumulative bill could no longer exceed a set percentage of their property's market value: 1% for residential homesteads; 2% for non-residential homesteads; and 3% for all other property. Property tax caps were statutorily passed in 2008 and made effective in 2009, but policy makers were concerned that if

[4] See Ryan (2010) and Association of Indiana Counties (April 2008). State gaming taxes, along with sales and income taxes "previously deposited into Property Tax Replacement and Reduction Funds redirected into the State General Fund to pay for levies." Association of Indiana Counties (April 2008).

they were not placed in the state constitution they might be ruled unconstitutional by a future court, or merely changed by a future General Assembly. The electorate approved Public Question 1, amending Article 10 of the state constitution on November 2, 2010.

HEA 1001 also legislated a few other fiscal reforms. There was the belief in the political body that construction costs, especially spending on non-instructional K-12 capital projects, required additional voter oversight and input. So the legislation also required referenda for new school and local government capital projects for elementary and middle school projects greater than $10 million, high school projects greater than $20 million, and local government projects greater than $12 million or 1 percent of property assessed value. Tax rates passed by referendum would be "outside of the property tax caps" in that the tax bills supporting them could not be included in the calculations used to determine if a taxpayer was at their respective cap. The reforms also substantially expanded local option income tax authority at the county level allowing an increase in CAGIT and expanding County Option Income Tax (COIT) levy authority for three additional tax rates: 1) to freeze (non-school corporation) operating property taxes; 2) to reduce existing property taxes; and 3) to pay for public safety expenditures.

While the expansion of local income taxes in Indiana since 1973 generated additional revenue for local governments, making up for some of the reduction in property tax revenue, the hodgepodge of the different COIT, CAGIT and CEDIT taxes and rates resulted in a confusing local income tax structure. In 2015, HEA 1485 consolidated and simplified all the local income tax laws into a uniform legal structure under Indiana Code (I.C.) 6-3.6. It phased out existing laws for local option income taxes, including CAGIT, COIT, CEDIT, and various other special purpose Local Option Income Taxes (LOITs), effective January 1, 2017, and created a single local income tax with different rates (property tax relief, expenditure and special purpose). HEA

1485 also established Local Income Tax Councils (LITCs), consisting of the fiscal body of the county and the fiscal body of each city or town in the county. In all counties only LITCs have the authority to take action regarding county income taxes. Allocation of votes is based on the relative population of the unit to the populations of all members, with total votes of 100 for all members, with a majority needed for approval (I.C. 6-3.6-3-6).

In 2016, the Indiana General Assembly passed authority for counties to increase the wheel tax and annual license excise surtax on motor vehicles for local transportation funding. This should provide local governments with an additional stream of own-source revenue for transportation spending, but is unlikely to significantly reduce the volatility of the local revenue structure.

3. Long Run Historical Analysis of Revenues

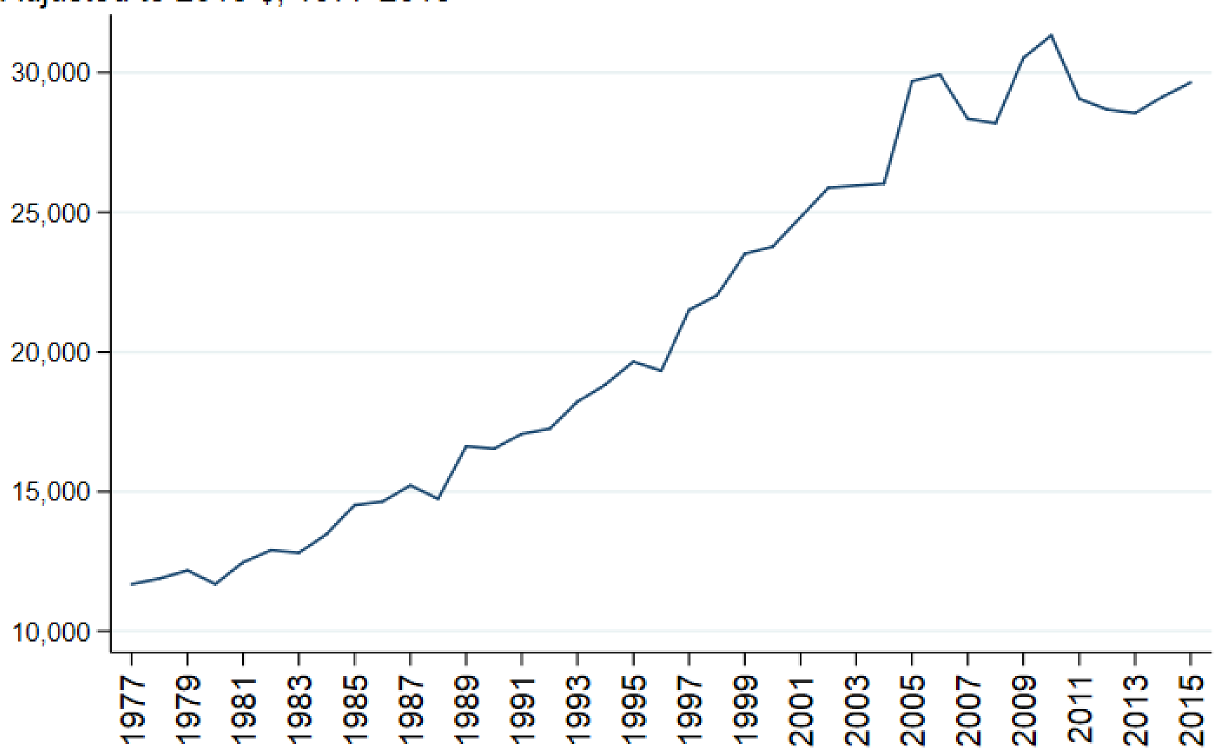
Most public finance observers point to 1973 as the year the General Assembly and Bowen Administration fundamentally changed local public finance in Indiana. Though property tax limits were first put in place in the 1930's (Stullich, 1990; Bennett and Stullich, 1992; Faulk, 2013), in 1973 the state government established the policy of exchanging local property taxes for local income taxes and state sales taxes. This section analyzes local revenues in Indiana using U.S. Census data from 1977-2015, focusing primarily on own-source revenues.

Structural changes in local revenue come from policy changes (e.g. increasing reliance of LOIT) as well as fluctuations in the business cycle (e.g. the Great Recession) and shifts in the structure of the economy (e.g. the rise of the internet and service economy). Indiana's local fiscal structure is the result of changes to the state constitution, changes made in statute by the Indiana

General Assembly, and administrative changes made by executive branch agencies responsible for implementing the local fiscal system, particularly the former State Board of Tax Commissioners and the Department of Local Government Finance (DLGF).

Changes in economic activity throughout the business cycle are also reflected in changes in the tax base. Prior to the imposition of the local option income tax in 1973, changes in the tax base were changes in the real estate base. Since 1973 the local tax base includes income, which is more volatile than the real estate base, making the entire local tax base more volatile.

Figure 3.1: Total Local Government Revenue (Millions)
Adjusted to 2015 $, 1977-2015



Source: U.S. Census Bureau

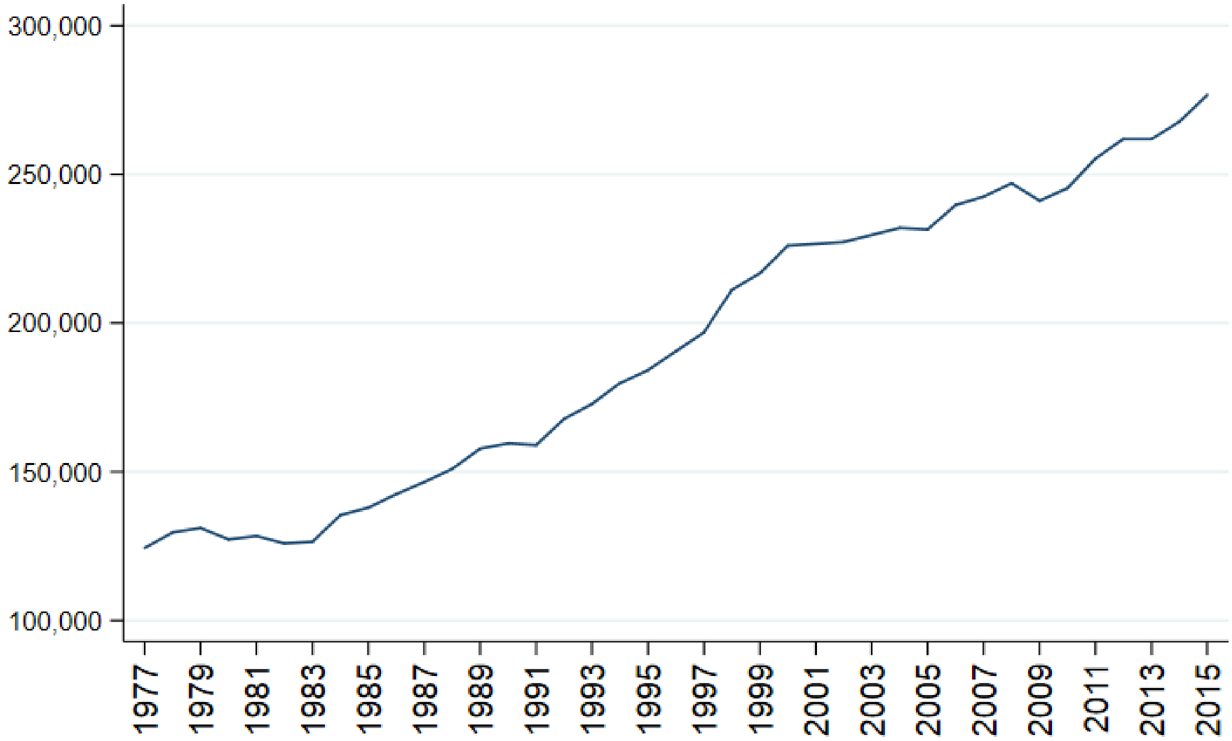
The year 2004 represents a structural change in total real local government revenue, as shown in Figure 3.1.[5] Local revenues are more volatile after 2004 in that changes from one-year to the next begin to fluctuate more rapidly. Total tax revenues increased from 2004-05 by 14%, the largest single-year increase over the 1977-2005 timeframe. Local income tax revenue took off from the expansion of the CEDIT and a steady increase in real total personal income from 2000-04. In addition, changes in the property tax assessment system from *St. John* were starting to filter through the revenue system.

Total revenue, however, dropped sharply between 2006 and 2008, from a steep drop in property taxes, likely resulting from the property tax caps. There was another large increase from 2008-2010, from a large increase in local income tax revenue and property taxes returning in some measure to pre-recession levels. Total revenues, however, suffered a large decrease from 2010 to 2013. Local income taxes peaked in 2010 and property taxes decreased from circuit breakers. Such volatility was unseen prior to 2004. There were significant dips in real revenue in several years: 1979-80, 1987-88, 1995-96, but nothing like the 2006 and 2010 drops. Indeed, real total revenues increased steadily from 1996 to 2004.

Revenue losses in 2006-07, 2009-10, and 2011-2013 correspond to a slight drop in real personal income in 2004-05, a large drop in 2008-09, and a flat 2012-13. Real personal income in Indiana from 1977-2015 is shown in Figure 3.2. The 2008-09 drop in real personal income was the largest recorded since 1977. Decreases in real total personal income have preceded decreases in real local government revenue.

[5] The data used in this report comes from the U.S. Census Bureau's Data Base on Historical Finances of Federal, State and Local Governments, unless otherwise indicated. Also, in analyzing the data we convert nominal dollars to real $2015 dollars, unless otherwise indicated. See Appendix 2 for a more detailed description of the U.S. Census Bureau data.

Figure 3.2: Total Statewide Personal Income (Millions)
Adjusted to 2015 $, 1977-2015

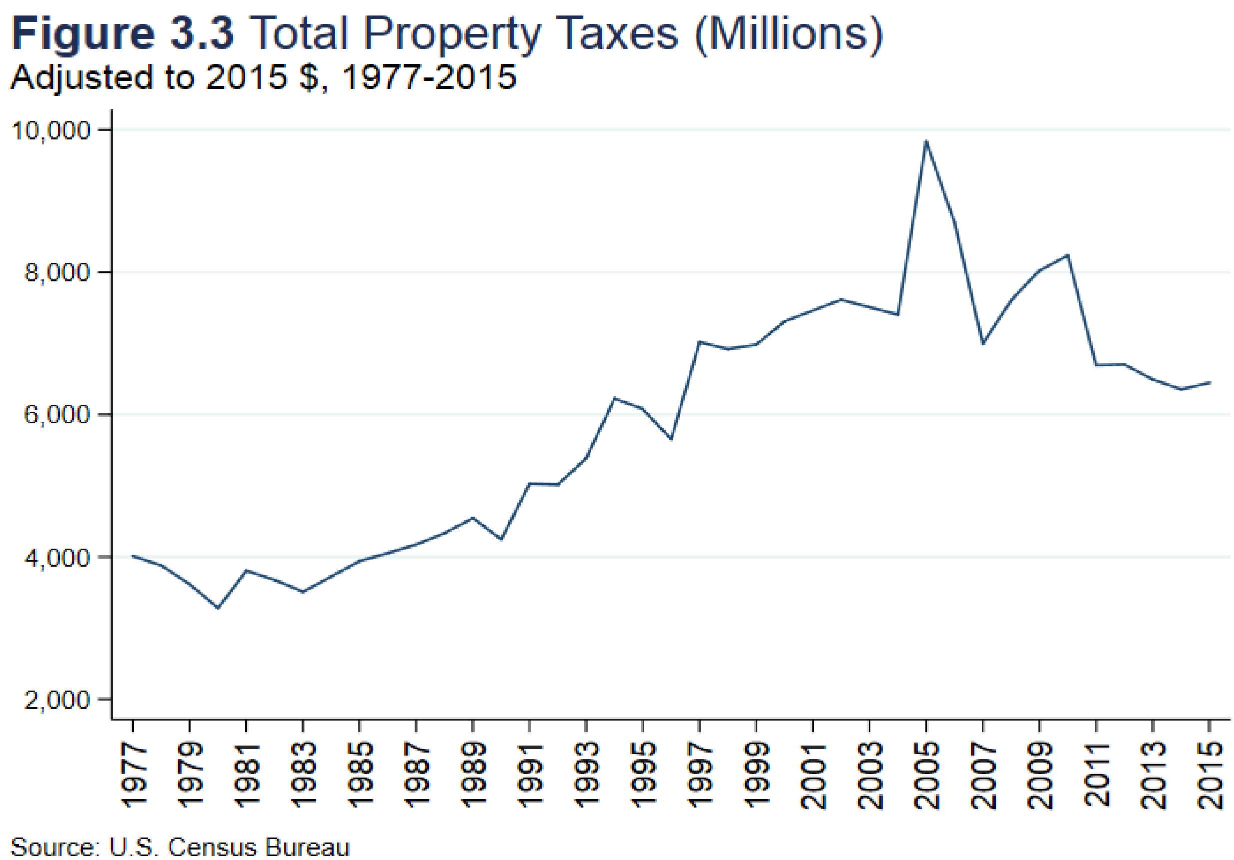


Source: U.S. Census Bureau

Constitutional, legislative, and administrative changes to the property tax and local income tax systems since 2002 have also had an impact on total revenues, which in real terms for 2015 have fallen back to their 2010-11 levels (see Figure 3.1). This is in no small part due to policy changes in the property tax system that have reduced property tax collections. The reduction in real property taxes is a result of structural reforms to the taxing system, not just the performance of the Indiana economy.[6] Real property taxes adjusted for inflation took a hit in 2002 (see Figure 3.3), partially in response to changes in the local fiscal system made in a special session of the General Assembly. P.L. 192 increased the standard homestead deduction from

[6] Indiana real gross state product decreased between 2007 and 2009. Since 2009, however, it has steadily increased, and is at an historic high. Indiana real personal income has increased steadily each year since 2009, with the exception of a flat 2012-13 (see Figure 3.2).

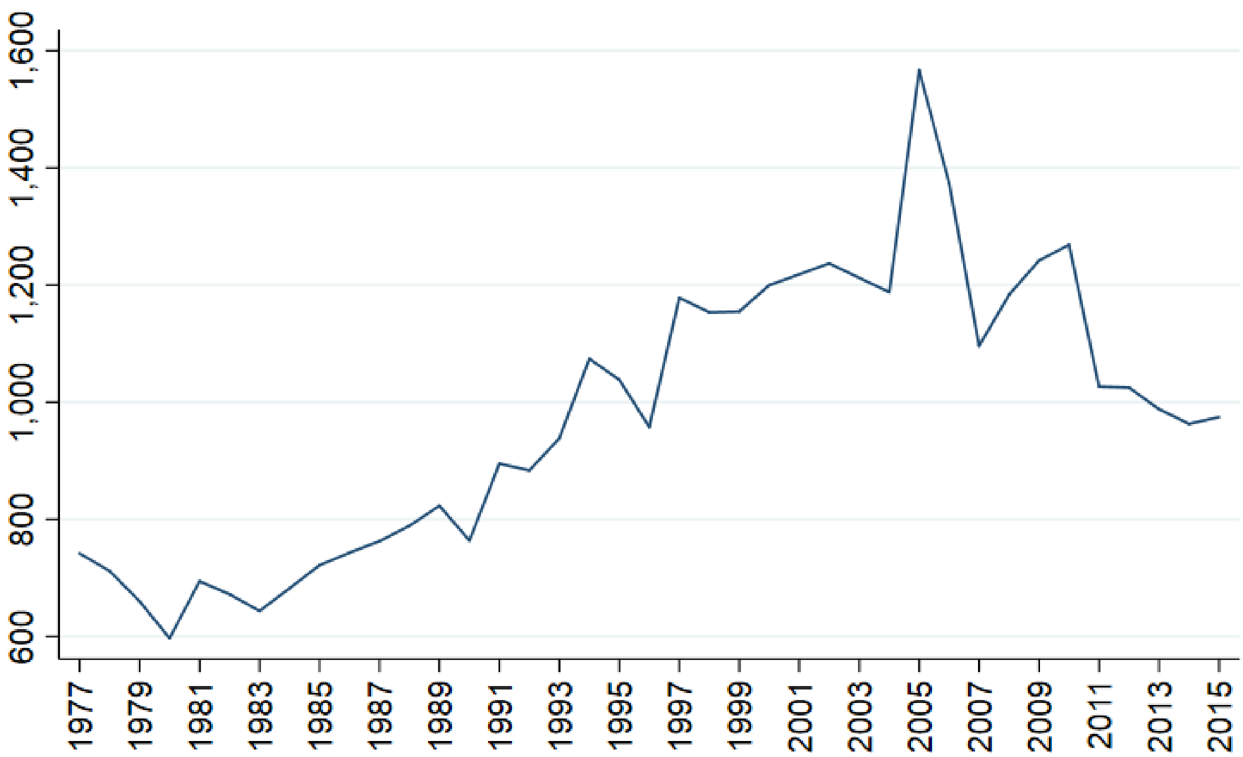
$6,000 to $35,000, required counties to eliminate the personal property inventory tax effective in 2006, enabled counties to levy a CEDIT to replace lost inventory tax revenues, and increased the state sales tax from 5 percent to 6 percent to provide additional local property tax relief.



There were several significant dips in real property taxes from 1977-80, 1981-83, 1989-90, 1994-96, 1997-98, and 2002-04, but nothing like the fall from 2005-07, and again from 2010-2014 with the establishment of the property tax caps and property-to-sales tax swap for K-12 education in HEA 1001. In 2015 (the last year of available Census data) real property taxes in Indiana were back to what they were in 1996-97. It is also evident that the individual property tax burden in Indiana has been substantially reduced when observing the similar decline in real per capita property taxes (Figure 3.4).

Though the individual property tax burden has been reduced, changes in both local property and income taxes in recent years indicate that revenue uncertainty for local governments has grown as Indiana's local revenues have become more volatile. Both the property and income tax are responsible. Property tax revenue took large hits in 2005 and 2010. Since 1977 real property tax revenues have shown increases and decreases, but not the substantial volatility shown from 2004-2014 (see Figure 3.3).

Figure 3.4: Per Capita Local Government Property Taxes
Adjusted to 2015 $, 1977-2015

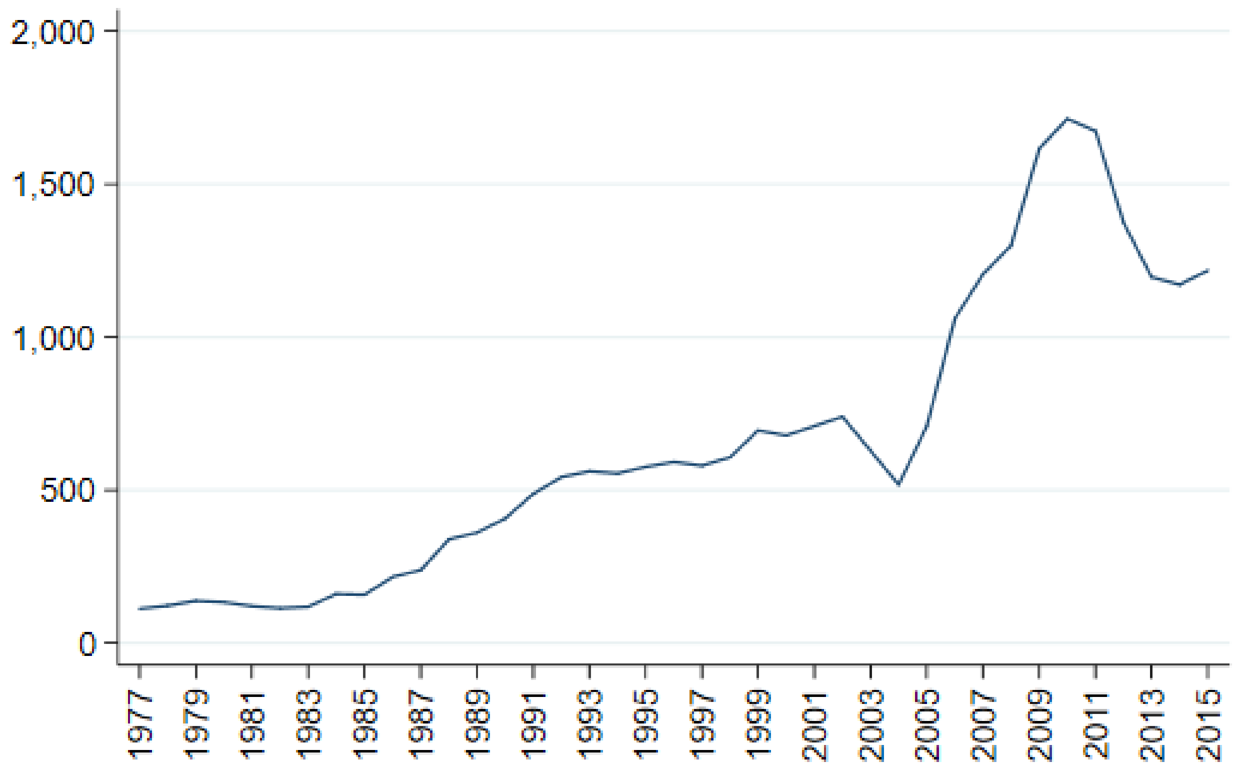


Source: U.S. Census Bureau

The local income tax demonstrates even more volatility than the property tax. From their original imposition in 1973, local income taxes have grown to 15.2% percent of local government tax revenue in 2015 (see Figure 3.5). Much of the growth has been recent, with local income taxes tripling from 2004-10 as more counties adopted the tax and increased their rates.

The recent growth of income tax revenue is coupled with its increased volatility. There have been major income tax drops in 2002, 2010, and 2011. The 2005, 2010 and 2011 decreases in local income tax revenue follows the reduction in Indiana real total personal income in 2004-05 and 2008-09. The 2008-09 personal income decrease was the steepest drop (-2.4%) within the 1977-2015 timeframe. The steep decline in local income tax revenue that started in 2010 continued through 2014, with real income taxes now back down to 2007 levels.

Figure 3.5: Total Local Income Tax Revenues (Millions)
Adjusted to 2015 $, 1977-2015



Source: U.S. Census Bureau

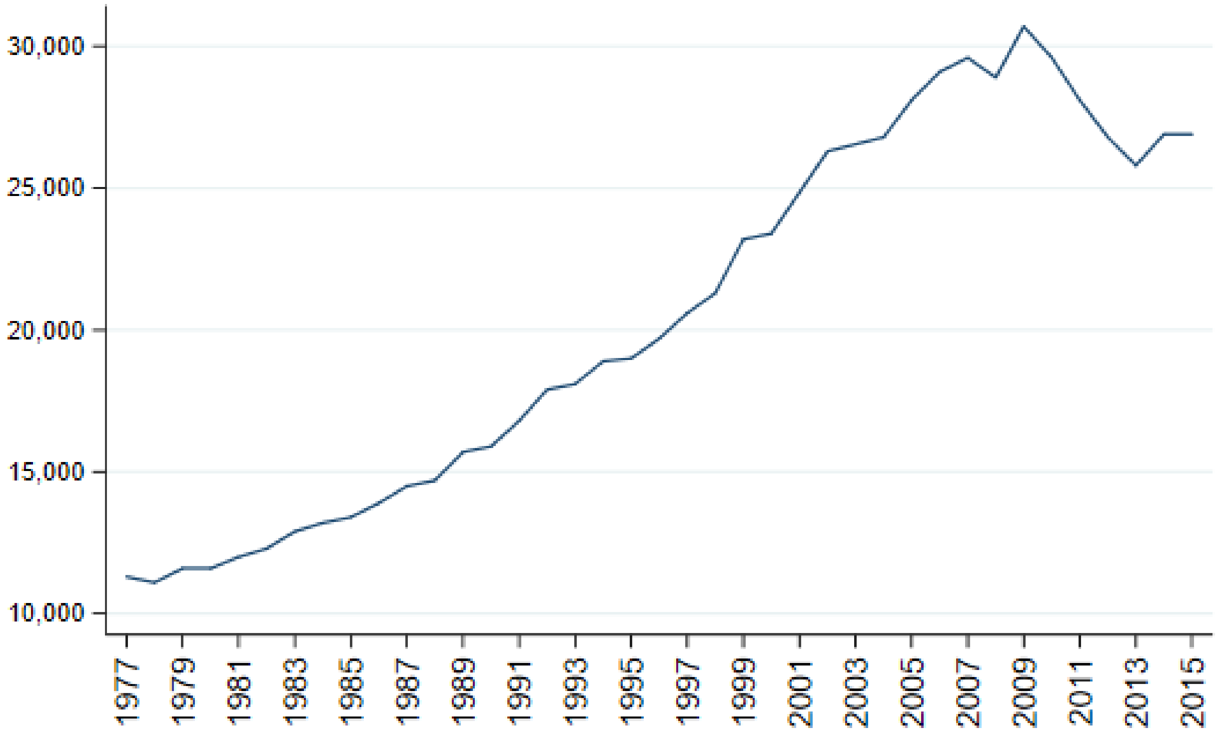
The change in the state government's overall fiscal relationship with local government includes changes to the state sales tax and the state assuming funding for certain traditional local government functions. The state has taken over several local general government and school corporation funding responsibilities, and has increased the state sales tax rate from 2 percent to where it stands now at 7 percent, in order to do so. The changes at the state level, coupled with the reduction in own-source local revenues, represents a fundamental transformation of Indiana's intergovernmental revenue system.

4. Long Run Historical Analysis of Expenditures

The last 40 years of local government expenditures should be viewed as "before and after 2009." While it is tempting to consider this as a consequence of the tax base implications of the Great Recession, the timing also coincides with significant reforms enacted in HEA 1001 (2008).

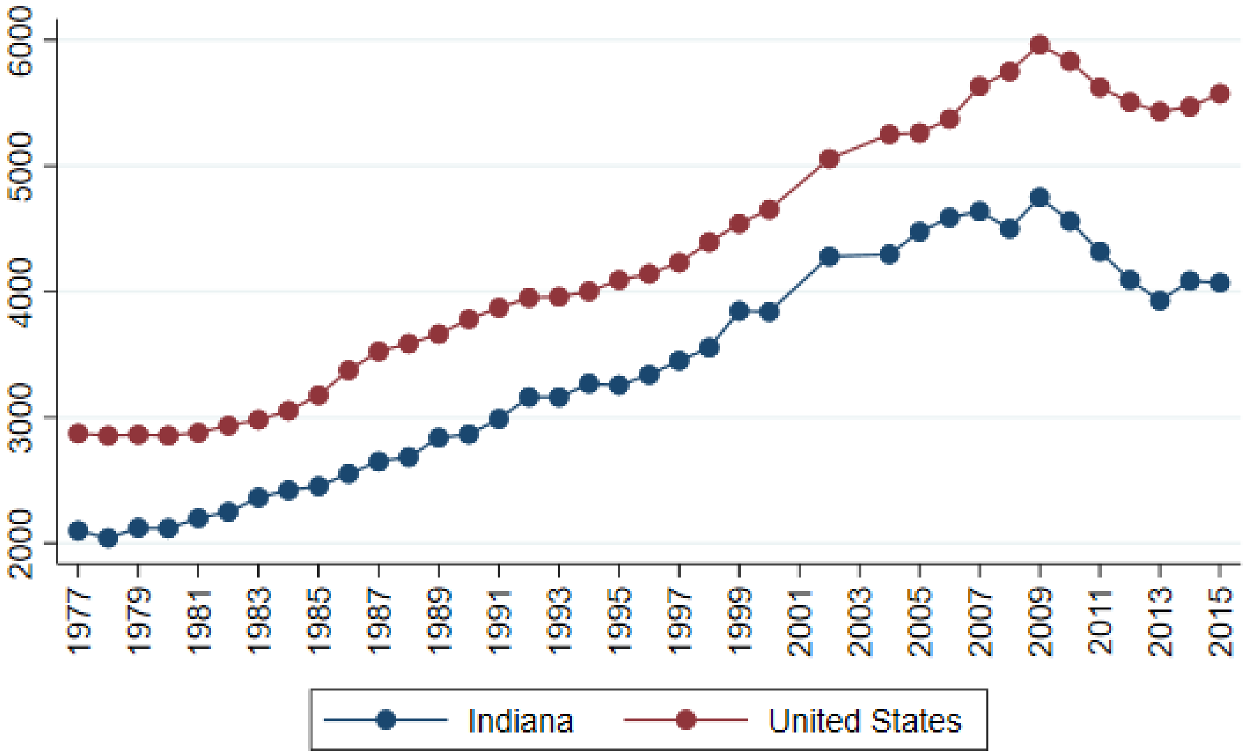
From 1977 to 2015 real total expenditures by local government units have grown at an average annual rate of 2.3%, or about 1.8% on a per capita basis. In real terms, expenditures on local government activities reached their peak in 2009 in both per capita and aggregate outlays. In 2015 dollars, local government activities accounted for just over $30 billion of public expenditures (see Figure 4.1), around $4,750 per capita. These figures were about 2.5 times their inflation-adjusted levels in 1978 (See Figure 4.2). The rate of growth of local government expenditures slightly outpaced the national average prior to 2009, albeit this was at persistently lower levels. For instance, the nationwide mean per capita expenditures on local government activities was about $800 higher than Indiana in 1977, but Indiana had doubled that level by 2000, whereas the national average would not double until 2008. Consequently, the national per capita expenditure difference from Indiana rose from $800 in 1977 to about $1,200 in 2008. About 40 percent of local expenditures come from public schools, but the pattern of expenditures in public education tracks the same trends as the rest of the local public sector.

Figure 4.1: Total Expenditures (Millions)
Adjusted to 2015 $,1977-2015



Source: U.S. Census Bureau

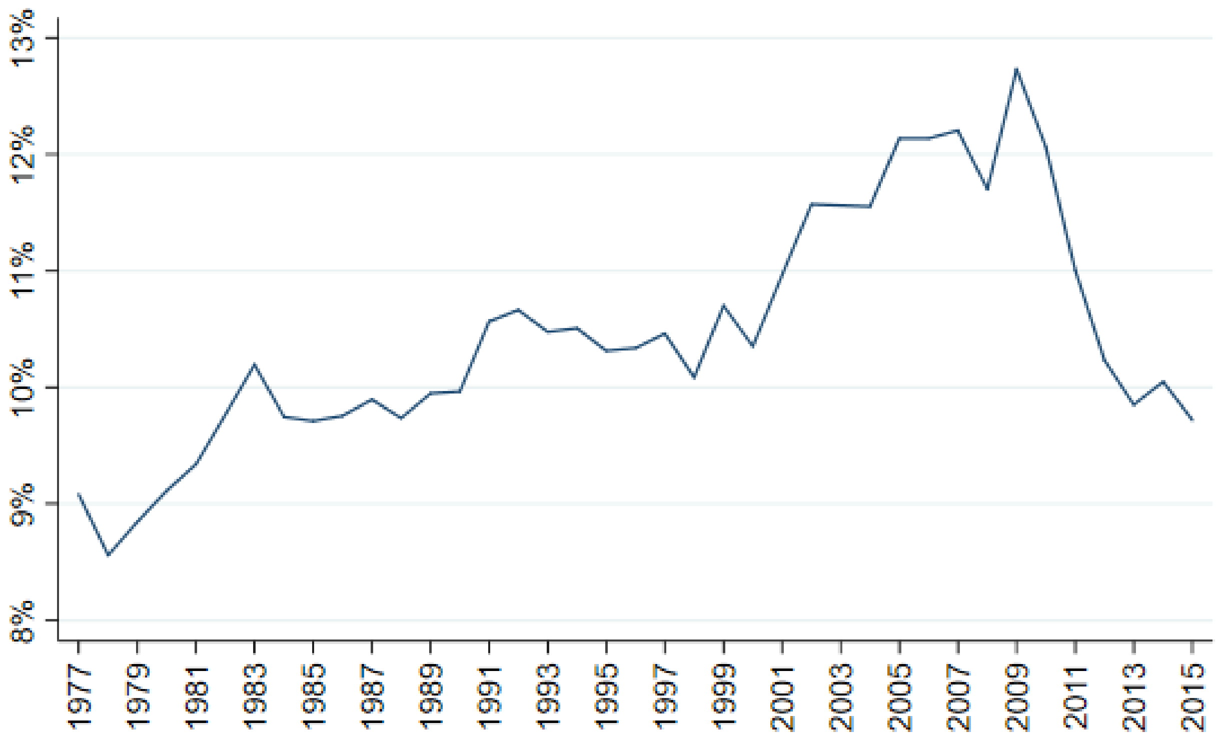
Figure 4.2: Per Capita Local Public Expenditures for Indiana and U.S. Adjusted to 2015 $, 1977-2015



Source: U.S. Census Bureau

These differences from the national trends are somewhat attributable to Indiana's difference in propensity to spend on local government from income. Only about 9 to 10 percent of Indiana's total personal income was consumed by local government expenditures prior to 2000, about two percentage points less than the national average. In the 2000 to 2009 era Indiana and the rest of the nation are similarly spending around 12 percent of personal income on local government activities.

Figure 4.3: Total Local Expenditures as Percentage of Total Personal Income Adjusted to 2015 $, 1977-2015



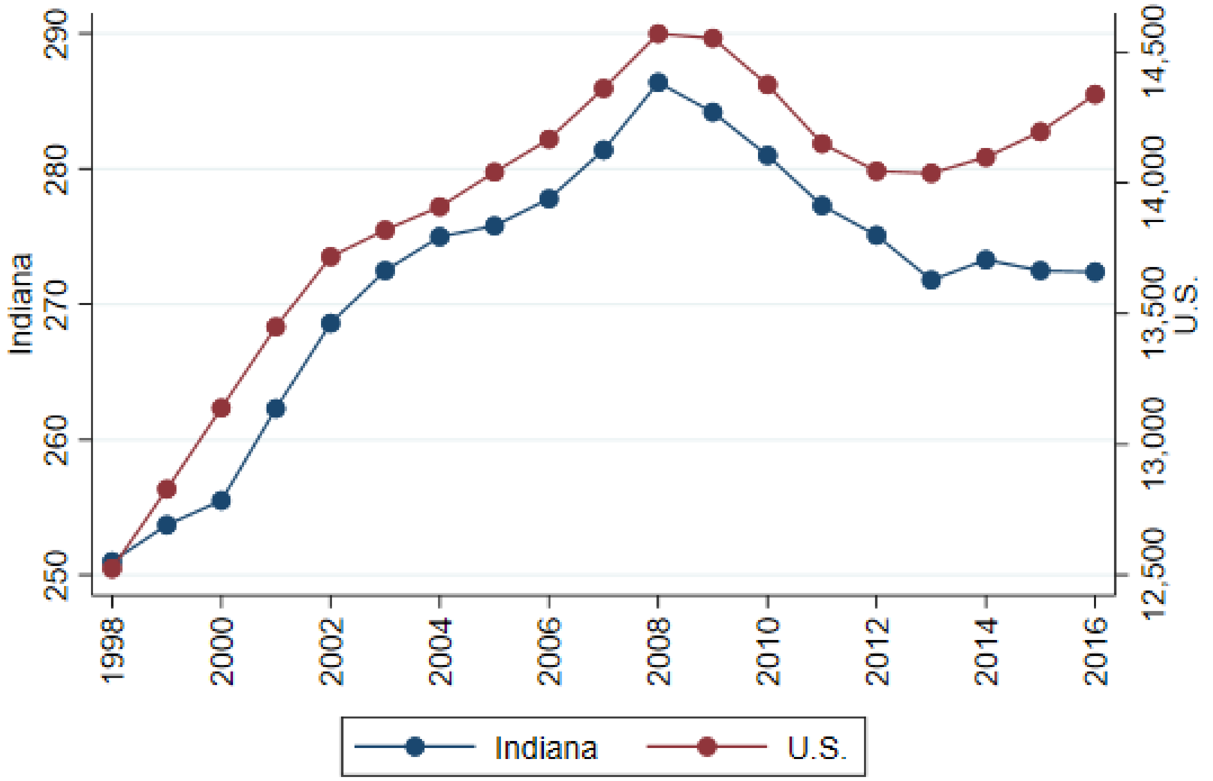
Source: U.S. Census Bureau

Since 2009, Indiana has had an exceptional decline in local public expenditures. For four consecutive years, Indiana's local governments cutback expenditures on average by more than 3.5% in each year in real terms. Similar belt-tightening occurred across the United States, but no more than -2.5% in a single year. Nationwide, real total expenditures on local government activities broke from a steep and steady increase to face several years of slow decline that bottomed out in 2012. By 2015, total expenditures had nearly returned to their 2010 levels, and on a per capita basis the national average is about 93% of its historical peak in 2009. Indiana, by contrast, took a much sharper decline that brought expenditures to its lowest points in over a decade, approximately their 2002 level in both aggregate and per capita terms. The brunt of this decline occurred from 2009 to 2012, and the state has remained relatively constant since that time at around 85 percent of their 2009 level in 2015. Some of this break from the national trend is likely attributable to the property tax caps from HEA 1001, as state studies of the impacts have estimated that local governments in Indiana collectively lost about $430 million to the property tax caps in 2010 and that these losses had increased to about $740 million by 2016.[7]

The rapid decline in local public expenditures for the state and nation are slightly precipitated by very similar trends in local government employment (Figure 4.4). The number of local government employees reached its peak in 2008 nationwide, and within Indiana slightly declined in 2009 and substantively declined through 2012. Nationwide, local government employment has begun to rebound while remaining basically flat within Indiana. About 70 percent of the net employment losses in Indiana local government employment have come from education services.

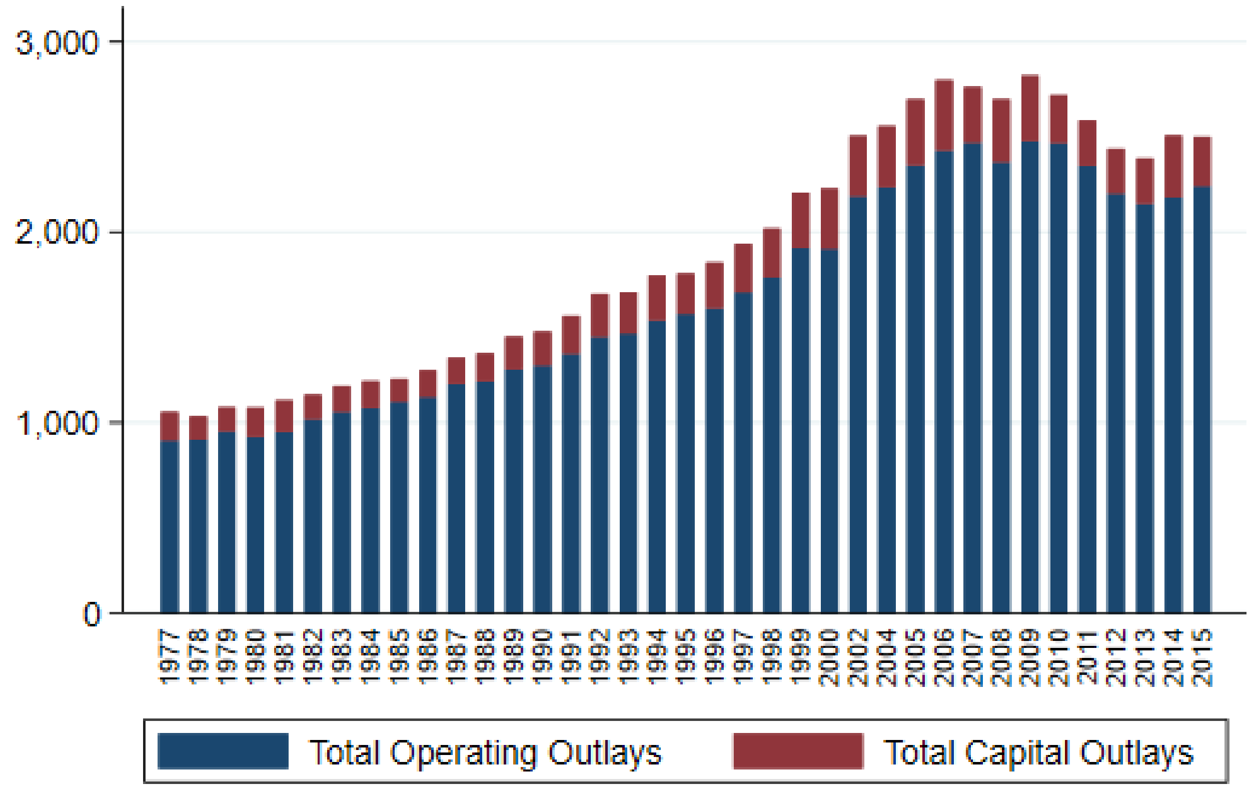
[7] DLGF annual reports on the impact of the property tax caps can be found at https://www.in.gov/dlgf/8379.htm.

Figure 4.4: Local Government Employment for Indiana and U.S. (1000s)



Source: U.S. Census Bureau

Figure 4.5: Total Operating & Capital Outlays by IN Local Governments Adjusted to 2015 $ (Millions), 1977-2015



Source: U.S. Census

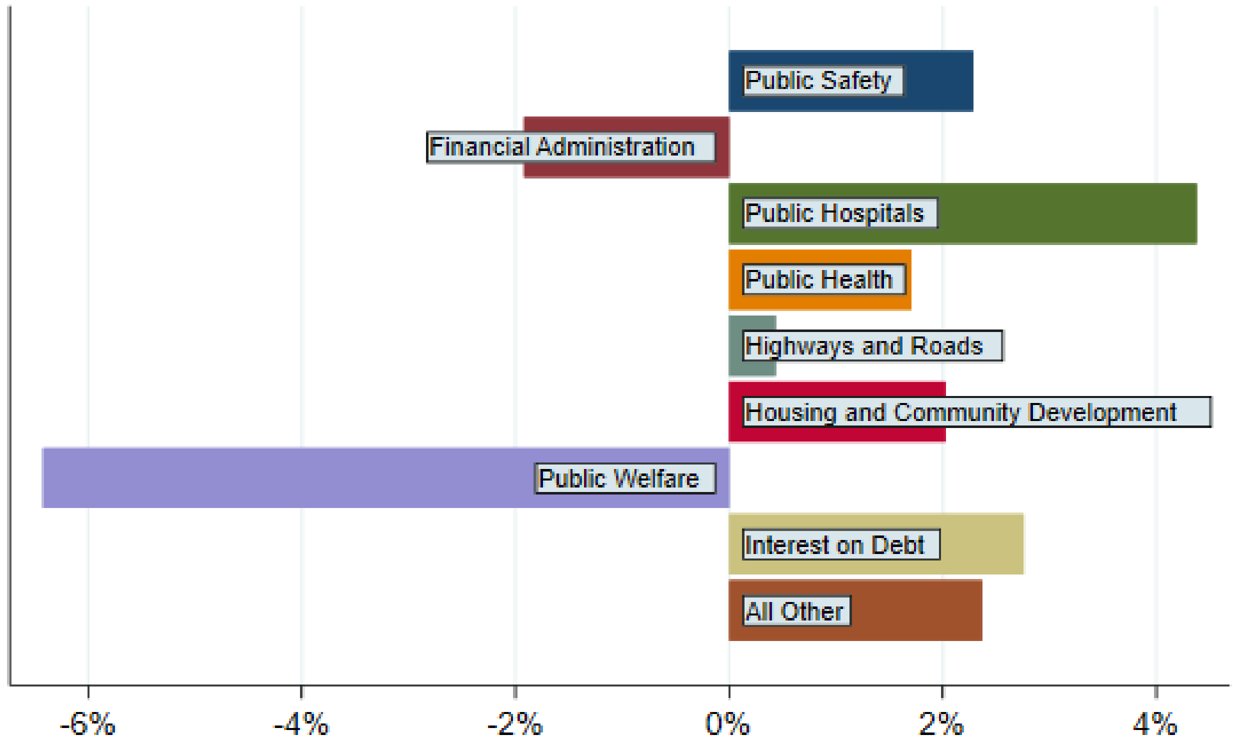
How monies are spent at the local level has also changed somewhat over time. Figure 4.5 displays the split of outlays on operations versus those on capital investment. In the 1970s and early 1980s, expenditures on capital was about 15 cents of every dollar spent on operations, and this figure shrank slightly to about 13 cents with the subsequent growth for the rest of the time series going into 2009. Since 2009, for every dollar on operations there has only been about 10 cents on capital infrastructure. There is no particular reason to think this trend has been a positive or negative development. Many capital projects need only be built once and then only incur maintenance investments. What we cannot tell is if this slight trend represents a deference in maintenance, a slow-down in new projects, or a natural decline rewarding current taxpayers for yesteryear's investments. Furthermore, as the revenue stream has become more volatile, local governments might rationally respond by taking fewer long-term commitments in their expenditure budget.

Figure 4.6: Expenditures on Local Government Activities, 1980 and 2015

Figure 4.6 shows the 1980 and 2015 divide between expenditures on utilities, education, and all other governmental activities for local government units. The majority of expenditures in 1980 were attributable to governmental services, with public education representing the second largest grouping. Within governmental services, expenditures on interest and debt and welfare assistance were the largest share of the expenditures. These were followed closely by spending on roads, highways, hospitals, and public safety (police, fire, and corrections). In 2015, however, expenditures on education and utilities have expanded so that governmental services

expenditures no longer represent a majority of all public expenditures. Within governmental activities public safety has expanded the most. The gains in public safety seem to be at the expense of welfare assistance in particular.

Figure 4.7: Average Annual Per Capita Expenditures Growth Rates by Governmental Function, 1977 – 2015



Source: U.S. Census Bureau

This shift in budget representation over time depicted in Figure 4.6 is a result of both levels and differences in growth rates over time, so Figure 4.7 demonstrates the real average annual percent growth rate of these governmental functions.[8] Public welfare and fiscal administration have both declined over time, albeit public welfare is heavily driven by HEA 1001 (2008), which shifted welfare administration from local governments to the state. The fastest growing function as measured by government expenditures are those related to public

[8] Average annual growth rate is calculated as ([(Value in 2015)/Value in 1977]^(1/38)-1)x100.

hospital services at 4.3%. Interest on debt, the second highest function category, has grown at a rate of 2.7%. Public safety, the largest governmental function, has grown at a real rate of 2.3% since 1977.[9] Highways and roads spending has grown, but lags most other spending categories, increasing only 0.43%. By contrast, real per capita personal income growth has been 1.5% over the same time period.

Expenditure management in local governments is partially organized through organizational forms. General purpose governments (counties, municipalities, and townships) carry out many of the core government functions. Special districts include schools, many utilities, and other functions outsourced from general purpose governments. Fire protection, for instance, is one that may be operated as part of a general purpose government or as a special district, and the choice to organize that service independent from general government is an ever evolving one that changes over time. As development occurs, how to best deliver fire protection may no longer adhere to the administrative boundaries of the local government. Legal restrictions on permissible growth in governmental levies can also affect the decision to split off. This can be true of parks, policing, hospital access, and schooling where geography, growth, and rules interact to generate changes to the configuration of local governments for service delivery.

Based on counts of local governments performed every five years by the U.S. Census Bureau, Indiana has long been an intensive user of special districts. Excluding public school districts, Indiana had the 8th most special district governments when counts began in 1942, at which time Indiana had 229. For comparison, more than half the states of the time had fewer than 100. Like the rest of the US, the use of special districts in Indiana has expanded

[9] Within public safety, fire and policing services have grown at a rate of 2.4% and 1.6%, respectively.

considerably. Nationwide, the number of local special district governments has increased with every Census survey since 1942 through the most recent in 2012. While this has been a steady national trend, within Indiana it has mostly taken place in a couple of waves. Indiana grew special districts from 1942 to 1972, then was relatively flat for the ensuing two decades. About 300 new entities were added between 1992 and 1997 to bring Indiana around 1,200. This remained through the 2007 census, at which time Indiana had the sixth most special districts in the nation.

Table 4.1: Indiana Special Districts by Function, 2012

Function	Count
Libraries	297
Environment and housing - Natural Resources - Soil and water conserv	94
Environment and housing - Sewerage	91
Environment and housing - Solid waste management	71
Environment and housing - Housing and community development	70
Environment and housing - Natural Resources - Drainage and flood cor	41
Sewerage and water supply	16
Social services - Hospitals	10
Utilities - Water supply	10
Environment and housing - Parks and recreation	9
All Other	43
Total special district governments	752

Source: U.S. Census Bureau

Where Indiana has departed from the national trend has been between the 2007 and 2012 survey. Nationally, about 1,100 special districts were created on net, albeit about 23 other states on net experienced small decreases. Indiana, by contrast, on net shed 520 special districts as part of a broad effort towards local government consolidation.[10] This brought Indiana down to an

[10] The commonly cited impetus for the consolidations is the recommendations from the 2007 Indiana Commission of Local Government Reform charged by Governor Mitch Daniels and chaired by Joseph Kernan and Randal T. Shepard (https://indianalocalgovreform.iu.edu/).

estimated 752 special districts, of which libraries represented the most common form (see Table 4.1). For comparison, the second largest net reduction was 74 units in Idaho. Consequently, the total number of local governmental units in Indiana dropped from 3,232 in 2007 to 2,710 in 2012, the lowest level since 1967. Almost all of this net reduction in Indiana came from special districts, and Indiana dropped from 6th to 13th when ranking the states by number of special governments.

These same 5-year surveys also permit subsamples of local governmental units to be estimated for their contributions to total local expenditures. The general purpose governments all experienced declines from the 2007 to the 2012 survey on a per capita basis. At the national level, general purpose governments are near the 2007 level in 2012, and cities in particular are slightly above it. Indiana general purpose units, by contrast, remains below their 2007 levels. This is particularly true of Indiana counties, where the decline between 2007 and 2012 is almost $200 per capita, which itself represents about 45 percent of the total decline in Indiana local government expenditures. A sizable chunk of the decrease in Indiana county expenditures comes from the release of welfare administration functions as part of House Enrolled Act 1001 (2008). This drove the county per capita expenditures on what the census regards as “public welfare” from about $81 per capita in 2007 to $1.7 in 2012, representing about 40 percent of county expenditure declines. Of course, this does not imply a reduction in welfare services overall, but rather a shift in the responsibility to the state. While other expenditure responsibilities shifted to the state through HEA 1001 are not cleanly tracked through the census data system, a good portion of the county reduction is likely attributable to HEA 1001.

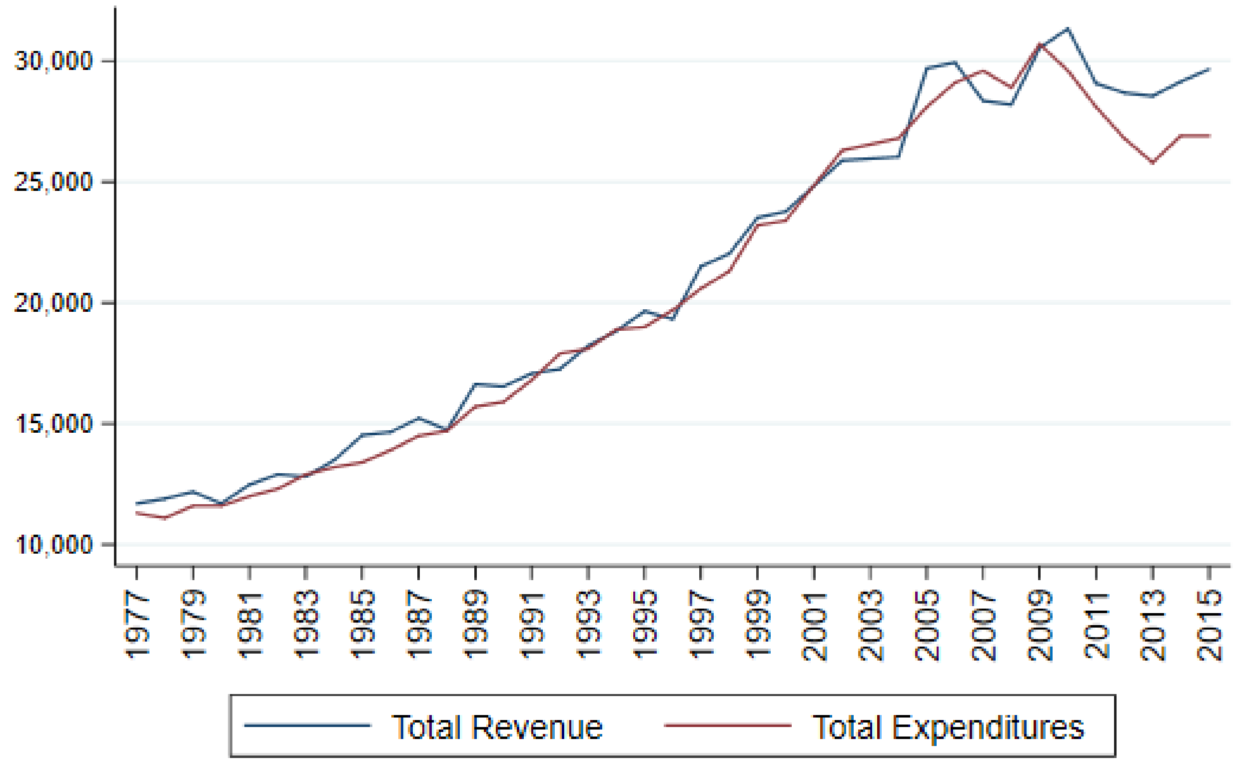
5. Synthesis: Outlook and Speculation on Local Fiscal Sustainability

Despite a local base of own-source revenues that is smaller and more volatile, broadly speaking, financing of local government services appears to be reasonably sustainable. For decades, Indiana's local governments have kept expenditures in line with revenues (see Figure 5.1). The size of the local public sector, measured by revenues or expenditures, as a share of the state's personal income is several percentage points below the national average, and consequently fiscal surpluses and deficits have generally remained less than 1% of personal income (see Figure 5.2). Furthermore, as reliance on local option income taxes has induced additional volatility into the revenue streams, local governments have coped with longer periods of surpluses.[11] This is particularly true since the Great Recession and implementation of the property tax caps.

What the overview suggests is that the typical local government has demonstrated sustainable expenditure management patterns within their revenue streams. This broad portrait does not address the quality or adequacy of local government services, and there may exist threats to future fiscal sustainability not revealed by the historical data that will now be discussed.

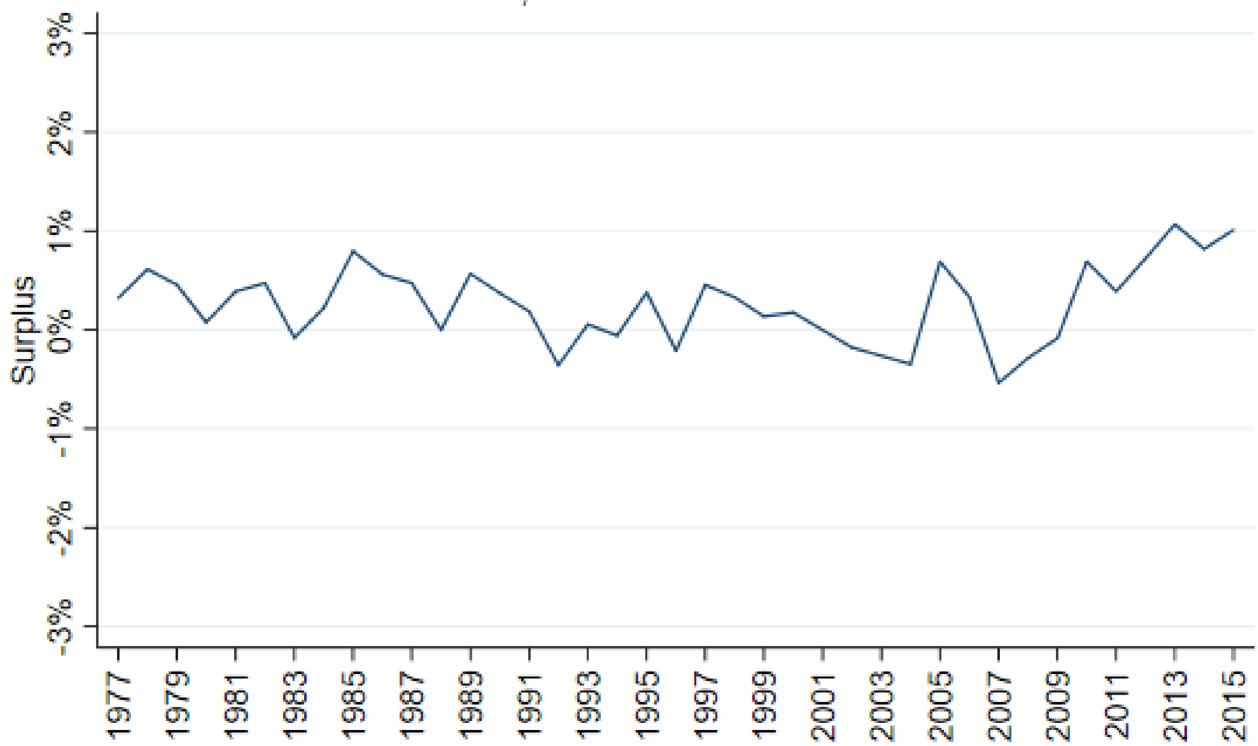
[11] Operating surpluses are likely the result of local units intentionally keeping spending below revenues to build up reserves and/or revenue stream volatility resulting in actual revenues exceeding expectations and thus planned expenditures.

Figure 5.1: Total Revenue v. Total Expenditures (Millions)
Adjusted to 2015 $, 1977-2015



Source: U.S. Census Bureau

Figure 5.2: Local Public Fiscal Surplus
as a Share of Personal Income, 1977-2015



Source: U.S. Census Bureau

State policy efforts to affect the composition of the revenue base has subsequently restricted access to the economic base. This can be a threat to the adequacy of local government provision of services, particularly where there exist unfunded mandates under federal or state law. Local governmental units have required obligations in numerous critical areas (e.g. fire protection equipment, prison operations, voting machines, property reassessments, water quality, education, infrastructure standards, etc.) that can result in costly lawsuits if they are not in compliance. Unfunded mandates on local governments can be an attractive mechanism for federal and state policy makers that are unwilling or unable to provide the financial support for services they would prefer implemented. Compliance with unfunded mandates require that local governments raise more own source revenue, but to the extent this is denied the only alternatives are reducing expenditures on other services, borrowing, drawing down assets, or risking non-compliance with the mandate.

As discussed in section 2, Indiana's state policy efforts in recent history have sought to diversify the tax revenue base away from property without encouraging expenditures. Most of these policies have been conventional in terms of what other states have attempted, namely restricting the ability to increase budgets or levies while also expanding the revenue instruments available. Limits on expenditure growth or restricting access to revenues are time-tested strategies used around the world for limiting the size of the public sector and encouraging fiscal sustainability. The property tax caps, however, represent a new challenge by offering a new twist on this strategy: once local governmental units have determined their new budgets/levies, having property owners who are at their maximum cap limit implies that their actual revenues will experience a shortfall relative to planned expenditures.[12] This in turn results in a structural deficit and possibly requires a new round of budgeting discussions once the actual revenues are established. In 2016, about 10% of local government levies issued in the state went uncollected due to property tax caps. Of course, the distribution of property tax losses can be much more substantive in specific areas, particularly where property values are low and service needs remain high. Clay Township's (Hamilton County) general fund collected only 79% of its levy due to the property tax caps, the Muncie Community School Corporation only collects about 70% of its capital projects, transportation, and bus replacement funds; Gary Civil City receives only a little more than one-half of their levies that support their general, police pension, capital development, and park funds.

[12] See Ross and Cheek (2014) for an analysis of the citizen level impacts of the property tax caps in terms of equity and service delivery.

Lake County offers a useful illustration of the challenges presented by the property tax caps and the interactive effects of the state's push for diversifying away from the property tax. Lake was the last county in the state to adopt a local income tax in 2013, and the fiscal events surrounding it illustrate the implications of these policy changes and the challenges they present for fiscal sustainability. In 2009, shortly after passing the property tax caps, state legislation required the local governments in Lake County to roll back their levies and remain frozen at those levels until an income tax that would lower the property tax burden was passed. All combined, local governments in Lake County had their certified levies decrease by about $12 million from 2008 to 2009.[13] One of the consequences became the basis of a class-action lawsuit settled for $7.2 million by the county that was brought forward by inmates of the Lake County Jail, as conditions were deemed to be inhumane to an unconstitutional extent.[14] The County itself lost about 10% of its levy, $12 million, in 2012 to the property tax cap circuit breakers. It was under these conditions that the county council capitulated and passed a series of income taxes: a 1% LOIT for property tax relief; a 0.25% CEDIT, and a 0.25% LOIT for public safety.

It is the 1% LOIT for property tax relief that provides the illuminating fiscal sustainability concern. The purpose of this rate was for every dollar to be used to reduce the property tax share of the county's tax levy, which would lift the levy freeze the state had passed in 2009. In 2014, the first full year of income tax collections, this revenue lowered the property tax levy by $97 million, meaning that about 78% of Lake County's levy was sourced by income taxes instead of property taxes. This reduction in property tax levies, however, was nowhere near sufficient to eliminate the structural deficit induced by the property tax caps. The $12.5 million

[13] Excluded from that $12 million reduction is the levy supporting welfare administration.
[14] Kwiatkowski, 2012. http://www.nwitimes.com/news/local/lake/crown-point/lake-county-to-pay-million-to-jail-inmates-in-settlement/article_e1e8f888-7c8b-55d2-98e1-78cffd9cd9e8.html.

in revenue shortfalls in 2012 were substantially smaller than the $97 million produced by the new 1% LOIT, but the property tax cap losses decreased to only $9.6 million for the county. Another way of considering the implication is to realize that the $9.6 million shortfall would still have occurred if the county instead had $0 in income tax revenue and simply cut expenditures by $97 million. Indeed, by 2017 the property tax cap losses have already exceeded their 2012 levels at $12.8 million as property values have remained depressed and property tax levies continue to grow. Gary Community Schools, which lose about half their capital and transportation funds to property tax caps, has recently had a state-appointed emergency financial manager take over the management of the school to aid in getting fiscal affairs in order.

In this light, the threat to fiscal sustainability under the property tax cap system is clear even if the mechanisms are convoluted. The purpose of a budget process should be to ensure that appropriated monies have an accompanying financial source. Typically, if revenues are to decrease by a dollar, then the budget process should assist in identifying a one-dollar reduction on the expenditure side. Alternatively, for a newly planned dollar of expenditure, the budget process should identify the funding source of that dollar. So long as a substantive portion of taxpayers have properties that are in excess of the 1-2-3 property tax caps, the budget will always have a shortfall that will require reworking after it is adopted and "finalized."

6. Conclusion

We find that the sustainability of local government finances in Indiana should be strengthened in preparation for the next economic downturn. The revenue system is now more vulnerable to the economic cycle, both in terms of lower levels of local, own-source revenues, and is significantly exposed to an elastic state government tax base heavily dependent on sales and income tax revenue. Cutting and transferring local public expenditures has enabled Indiana local governments to keep pace with declining own-source revenues. But it leaves local governments vulnerable to the inevitable revenue losses during the next economic downturn. While the authority to levy an excise surtax for transportation funding is helpful, it does not provide the local own-source revenues needed to fulfill the general funding gaps inherent in the structural deficits of Indiana's local governments.

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