Indiana FY2019: A bigger budget umbrella, cloudy human capital forecasts

Chris Watts, IFPI President – July 24, 2019

The end of June marked the end of Indiana's fiscal year, and after crunching the final revenue data and totaling up expenses, reversions and other adjustments, the state released its 2019 close-out report on July 12th – by the books, as Hoosiers have come to expect.

The major news coming out of the announcement from Auditor of State Tera Klutz and incoming Office of Management & Budget director Cris Johnston is better-than-expected revenue growth pushing the state surplus to historic levels. Looking at a few key developments behind the surprising surplus headline:

Highlights:

- Annual revenues surged ahead of the April forecasts, as the state collected nearly $267 million more than anticipated for FY2019, leaving budget reserves at $2.27 billion (13.9% of 2019's expenditures);
- All major tax sources outperformed (revised) expectations: Sales and individual income taxes beat forecasts by modest levels (0.6% and 1.7% respectively), while corporate taxes provided a $77 million added windfall (9% above estimates) and riverboat/racino taxes 'beat the odds' by a collective 4%;
- Among minor revenue sources, rising interest rates delivered the biggest bump to anticipated revenue ($15.3 million in 'extra' interest payments); the biggest percentage variance versus forecasts was from riverboat admissions (30%) – Hoosiers were gambling more, but taking slightly fewer risks with their health, as cigarette tax revenue was off -0.6% against predictions.

It all added up to revenues 1.7% above the April forecast revision ($266.8 million), or 5.4% growth over 2018 totals (the best year of growth since 2012).

How big an umbrella does Indiana need?

2019 marks a decade of consecutive budget surpluses for Indiana, but the size of the surplus makes it notable for more than this milestone: While Governor Holcomb and legislative fiscal leaders have embraced $2 billion (roughly 12% of annual expenditures) as a reasonable reserve level, the close-out showed a surplus of $2.27 billion, approaching 14% of the budget.

Indiana entered 2019 already among the better-insulated states against an economic downturn. According to the Pew Charitable Trust, we're among a handful of states with unfunded liabilities equaling less than 10% of total personal income and 'rainy day' funds sufficient to sustain state government well over a month. A year later, our ability to weather fiscal storms is even stronger.

But the size of the surplus wasn't greeted with unalloyed acclaim. Democratic lawmakers argued that excessive prudence shortchanged priorities like K-12 education (and teacher compensation) and other "human" investments. Concerns were bipartisan, as Speaker Bosma noted that a surplus above 12% of the budget amounted to "hoarding" taxpayer dollars without clear purpose.

Aiming for 12% - a short-term spend down:

While lauding the state's booming bottom line, Governor Holcomb agreed that the surplus could be modestly reduced for appropriate short-term expenses.

The Governor asked lawmakers to authorize paying for a number of planned capital projects out of reserve funds instead of bonding. By identifying roughly $300 million in construction to fund "in cash" versus via long-term borrowing, the state saves over $100 million in interest payments while maintaining $2 billion of the surplus (still above 12% of expenditures). Recommendations include:

- $50 million for the Indiana State Fairgrounds swine barn;
- $73 million for the Purdue College of Veterinary Medicine teaching hospital;
- $60 million for the Ball State University STEM and Health Professions facilities;
- $30 million for the Ivy Tech Columbus main building; and
- $78 to continue eliminating traffic signals and rail crossings to improve traffic flow along the length of U.S. 31.

A healthy surplus, strong revenue growth, the opportunity to pay off capital expenses and avoid added debt – FY2019 brought plenty of positives. But the close-out also offers the chance for a frank assessment, looking at less optimistic trends and potential challenges as well.

How good is the good news about Indiana's finances?

Indiana isn't an economic island, so it's also useful to look at the broader fiscal landscape to gain comparative perspective. Of course there are unique state-by-state circumstances (recent tax increases, boom-or-bust cycles in particular industries, etc.), but a bigger picture still emerges.

The "Fiscal Survey of the States" (2019) report from the National Association of State Budget Officers (NASBO) estimates the typical 2019 rainy day fund hovering around 8% of annual spending, so Indiana's 12% is an outlier. Does the data offer more insight into how we got here?

NASBO's survey shows most states experiencing robust revenue gains, buoyed by the national economy and federal tax reform. Indiana's performance is strong, but not unique. We're slightly ahead median revenue growth for FY2019 (after lagging behind in 2018), among a majority of states (28 and growing as NASBO issued the report) where revenues are exceeding predictions.

The Pew Charitable Trust offers a longer look back at revenues, measuring each state's growth over pre-recession (2008) levels. Indiana has rebounded to more than 8% above that level – but the 50-state average is over 13%. The data doesn't indicate we've grown our way to this historic surplus.

A more decisive factor is our hawkish stance on spending: NASBO analysis puts average state expenditure increases for FY2018 (over '17) and 2019 at 3.2% and 5.8%, respectively; Indiana's were 1.8% and 3.8%. And these increases build on a more frugal baseline, as Indiana spends about 80 cents for every dollar spent on a per capita basis by state governments across the nation.

Fiscal discipline is admirable and a hallmark of Indiana's recent budgetary history. But if a downturn erodes revenues, ongoing belt-tightening is only sustainable for so long.

Cloudy revenue forecasts?

It's also worth noting that while most revenue categories outperformed the April revised forecasts, Indiana's dominant tax sources finished in line with the earlier December 2018 forecast: Sales tax collections finished $6 million below original expectations, while individual income taxes exceeded the December forecast by $20 million.

The overall differences between forecasts are modest, but the reasons for April's downward revision are relevant: Weakening payroll growth, continued global trade tensions and a manufacturing slowdown (particularly in the automotive sector).

If the latest forecasts were simply pessimistic about the timing of these trends, it doesn't mean the same factors aren't still lurking as challenges to the state's finances over the next biennium. (And over the longer-term, that human capital deficits won't jeopardize Indiana's streak of surpluses.)

Prosperity…or austerity: Population & income trends shape Indiana's fiscal future

Even keeping these issues in mind, there's no cause to downplay Indiana's strong finish to FY2019 or raise concerns about revenue projections for the next biennium (with the caveat of a national recession affecting government tax collections and spending capacity at all levels).

But with 85 cents of every dollar in state revenue raised by individual income and sales taxes, any analysis of Indiana's fiscal climate should acknowledge the need for a larger and more competitively-skilled Hoosier workforce, earning – and spending – faster-growing wages. Current trends don't support this basic premise.

Over the last decade, Indiana's population growth has lagged the national average. Before an uptick last year, our rate of in-migration (new residents moving to Indiana) had steadily declined; from 2000-2017, annual in-migration was a roughly a fifth of what it was in the 2000s. These gains are unevenly distributed; all but 14 of Indiana's 92 counties are predicted to lose working-age residents through 2040.

Indiana also continues to rank annually among the bottom ten states in educational attainment (percentage of the population over 25 with education beyond high school). As education is a primary driver of earning potential, incomes have also failed to keep pace with the nation.

Indiana's per capita income has been roughly 90% of the U.S. since the 1980s, losing ground since the last recession: According to another Pew Charitable Trust analysis, annual personal income growth across the country has been 1.9% since 2007 versus 1.8% in Indiana, leaving an average Hoosier income of 87 cents for each dollar to the typical American.

Indiana's economy continues to grow. More Hoosiers are working than ever before as a decade-long recovery blunts the fiscal impact of sluggish population and personal income trends. But progress on these issues is critical to the state's economic potential and fiscal stability beyond the next biennium; policymakers are aware and actively engaged on these issues, and the size of today's surplus shouldn't distract from the scale of these longer-term challenges.