FY2021 Close-Out: How high is Indiana's post-COVID revenue bounce?

Commentary from the Indiana Fiscal Policy Institute – July 27, 2021

Last July, the COVID crisis had crushed Indiana's Fiscal Year 2020 revenues by more than a billion dollars, state agencies had cut or cancelled nearly $700 million in planned spending ($373 million in reversions, plus the reversal of $291 million in accelerated payments for capital projects), and budget officials were bracing for the prospect of worse to come.

What a difference a year makes. On July 14, Indiana's **FY2021 Fiscal Year Close-Out** report was released, chronicling a remarkable rebound from depths of the pandemic, with state revenues soaring to overwhelm statutory limits on the size of Indiana's surplus and give Hoosiers an automatic income tax credit in 2022.

Specifically, total state reserves reached $3.92 billion, or 21.5% of planned FY2022 spending:

- Tax collections from April through June exceeded even the blockbuster April 15 revenue forecast by $1.2 billion, pushing the general fund surplus to $2.6 billion;
- After transfers from the Medicaid reserve stabilized the financial outlook at the end of FY2020, a program surplus refilled the account to $214.7 million;
- Based on disruptions to K-12 (more at the top of page 3), unspent education appropriations triggered a transfer of $197 million to the state tuition reserve, bringing it to $550 million at year's end; and
- The supplemental 'rainy day fund' ended FY2021 at $537 million, for a grand total of $3.9 billion.

By law, any surplus outside the tuition reserve that grows beyond 12.5% of expenditures is divided equally between pension stabilization and automatic tax refunds. In this case, subtracting the tuition reserve ($549.5 million) and 12.5% of FY2022 spending ($2.3 billion) from $3.9 billion leaves $1.09 billion – or $545 million for refunds, to be divided equally among individual taxpayers *(see the calculation below)*.

About those refunds…

To avoid direct disbursements, the Department of Revenue will actually reflect the refunds as credits to be claimed on 2022 Indiana tax returns. The amounts will be determined based on the number of individual taxpayers, but could hit $170 for single-filers or more than $300 for household (joint) returns.

Combined Reserves at end of FY 2021	$	3,922.7
Less Tuition Reserve Balance	$	(549.5)
Net Combined Reserves	$	3,373.2
Less 12.5% of FY 2022 GF Appropriations	$	(2,282.5)
Excess Reserves	**$**	**1,090.7**
if > $50M, then:		
50% for Pension Stabilization Fund	**$**	**545.3**
50% for Automatic Taxpayer Refund	**$**	**545.3**

Excess Surplus Calculation (courtesy State Budget Agency)

But even though sending money to taxpayers is an obvious political boon, it wasn't a planned strategy. Governor Holcomb and the General Assembly had sought to manage the state surplus closer to 14-15% of expenditures by funding certain appropriations from FY2021 instead of the new biennial budget. The final version of the budget already included a shift of $600 million from planned reserves in addition to the $545 million that will now go to the Teacher Pension Stabilization Fund (the other half of the excess surplus).

Lawmakers also approved $110 million for advance bond payments, the costs of a new learning loss grant program ($150 million) and enhanced law enforcement training ($70 million – part of the fiscal impact of a broader police reform bill) from FY2021 resources. But revenue gains still outpaced these efforts.

Behind the Revenue Boom:

In fact, FY2021 revenues reached **$19.4** billion ($18.5 billion in revenue collections plus $886 million in income tax payments delayed by the filing deadline extension in 2020). This means FY2020-2021 general fund revenues totaled nearly $34.8 billion – **actually exceeding the pre-COVID (December 2019) forecast of just over $34 billion.** A significant mark, considering many experts predicted early in the pandemic that state revenues wouldn't resume a 'normal' trajectory until 2024 or even later.

A few notes on the evolution of state revenues in FY2021:

- By fall, it was clear that most of COVID's impact on income taxes was timing – even though economic effects were seen in monthly withholdings, the extended filing deadline in 2020 pushed nearly $900 million in tax payments from FY2020 into 2021;
- Sales taxes remained stable, as household spending on goods remained steady and Indiana reaped the rewards of a 2019 move to expand taxation of online transactions;
- In December, with monthly revenues continuing to edge above estimates (but the future of federal aid, the vaccine rollout and consumer confidence uncertain) the State Budget Committee received a revenue forecast predicting FY2021 revenues at $17.7 billion (3.5% "real" growth over FY2020 after adjusting for delayed income tax payments) and modest growth for FY2022-2023 ($34.95 billion);
- The revenue outlook continued to brighten, as unemployment continued to fall (with higher-paying jobs recovering at a faster pace, buoying income tax collections along with the continuation of enhanced unemployment benefits), the passage of the American Rescue Plan Act (ARPA) stimulating household spending and further easing of COVID restrictions in tandem with vaccine deployment;
- In mid-April, the **forecast update** added $463 million to its December revenue projections for FY2021 and boosted earlier estimates for FY2022-2023 by nearly $2 billion (helping Governor Holcomb and the General Assembly finalize a $37.4 billion budget with more than $18 billion for K-12 education).

But as described, even the April 15 forecast wasn't optimistic enough, as revenues surged ahead through June 30th to close the books on a surplus that's truly unprecedented (to use a COVID cliché).

The Spending Side:

In April 2020, Governor Holcomb ordered sweeping cuts across state government in response to the revenue disruptions and unanticipated costs of COVID – 15% for most agencies, with a more modest 7% for higher education and sparing K-12 expenditures. As mentioned in the first paragraph of this overview, these reversions ultimately totaled $373 million for FY2020.

FY2021 got off to a strong start with delayed income tax payments hitting the books in July and August. As general fund revenues continued to recover, pressure to curb spending eased as well; reversions for FY2021 finished at $257 million (less than FY2017 or FY2018, by comparison).

It's noteworthy that FY2021 reversions include a $12.8 million (5%) cut from the Department of Education, without tuition support (per student) aid. Education distributions did fluctuate as a result of COVID, but not as a result of executive order or efficiency measures.

In Indiana, most state education funding follows the student to support local schools. Districts receive monthly allocations based on fall and spring student enrollment (Average Daily Membership, or ADM counts). But COVID impacted attendance last fall: 15,000 fewer students in public schools during the September 2020 ADM count, a combination of parents delaying enrolling kindergarteners, choosing homeschooling or other alternatives in reaction to the public health crisis.

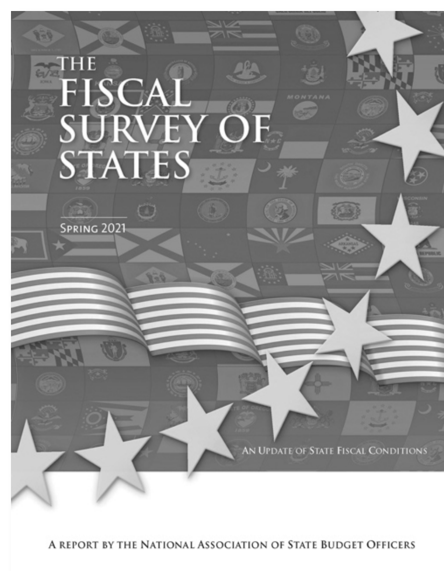
This meant tuition support to local schools also decreased for part of FY2121, staying in the general fund. COVID also caused declines in college enrollment (tracked in fewer high school students completing FAFSA paperwork by the Spring 2021 deadline), further disrupting programs like the Mitch Daniels Early Graduation Scholarship. So despite Indiana's commitment to protect K-12 funding – a commitment kept on a per student basis – the pandemic still created an effective $197 million education reversion.

The bottom line? Revenue growth overflowed Indiana's rainy day reserves, but FY2021 started from a cautious budget baseline. Lawmakers capitalized on the improving revenue situation during the session to shift spending to the current-year general fund, as mentioned in the opening: Another transfer to teacher retirements ($600 million) and a 1% cost of living adjustment for public pensions, $150 million for K-12 learning loss grants (HB1008) and $70 million to the Indiana Law Enforcement Academy (HB1006).

This equates to a 9% total increase in appropriations for FY2021 versus FY2020, keeping in mind that some of this spending carries into the new biennium, impacting programs conceived during the long session that would typically end up as provisions of the new budget.

National Context: Where does Indiana fit in the fiscal comeback?

The fiscal impact of COVID to state governments was more moderate than widely expected. According to the National Association of State Budget Officers' (NASBO) ***Spring 2021 Fiscal Survey of States***, 37 other states joined Indiana in seeing FY2021 revenues exceed forecasts, and 33 states saw total reserve balances grow from their pre-COVID levels (FY2019 through 2021).



But according to the NASBO data, Indiana's financial position is noteworthy versus the 50-state average in several ways:

- Indiana's total reserve balances grew to 21% of current year expenditures, versus nearly 14% across other states (acknowledging Indiana's 'head start' with higher reserves before the pandemic);
- Indiana revenues (even adjusting for delayed income tax payments) grew nearly 13% in FY2021 from 2020, versus a 3% state-by-state average;
- While FY2021 revenues beat expectations in most states, actual totals still lag FY2019 by more than 2% nationally – Indiana reverses this trend, with general fund revenues 10% higher than FY2019 (then hailed as a year of solid growth by Indiana's standards during the 2010s).

Looking ahead, NASBO reports that 15 states enacted tax increases effective in FY2022, while 19 states seized on favorable conditions to reduce taxes. Aside from adjusting the local business property tax exemption, Indiana took no action on the state tax code – but in reaction to the FY2021 close-out, Speaker Huston recently commented that the 2022 legislative session would include further discussion of "…sustainable tax cuts and reforms."

Proceed with Caution?

In response, Representative Greg Porter (ranking Democrat on the House Ways & Means Committee) said the remaining surplus still represented "an embarrassment of riches that could be better used to help our state's human infrastructure," emphasizing educational and public health disparities.

The General Assembly will reconvene in September to tackle redistricting, but the next regular session starts in January. Until then, there's a five-month window to assess the revenue outlook and whether the size of the surplus is prudent relative to the new biennial budget and the strength of Indiana's recovery.

When does the revenue surge subside? In discussing the Close-Out, Office of Management & Budget Director Cris Johnston noted that "Eventually we will fall back into this sort of range that we do normally experience…" But when? Heading into the 2021 session, are tax collections continuing to exceed estimates?

Beyond the monthly revenue reports, how long does the delta variant prolong the pandemic, and what toll does it take on the broader economy? Is consumer spending steady, shifting between goods and services (which Indiana doesn't tax) or slowing with inflation fears? Does payroll employment keep growing, and what's the fate of enhanced unemployment benefits?

What do we know about the impact of the 2021 session and the FY2022-2023 budget?
It's also difficult to make the case for tapping into the surplus outside the regular budget cycle without knowing more about the public investments that are already in progress.

For example, the new state budget includes $50 million for public health challenge grant – will elicited proposals offer new insights on the state of Hoosier health? READI regional development plans will be in the hands of the Indiana Economic Development Corporation by September; are there innovative strategies that should be elevated or shared statewide? What's the pace of participation in workforce programs like the newly-created Career Accelerator, and what does it reveal about the recovery job market?

The influx of ARPA funds to state and local government also means billions of dollars in planned or potential spending on infrastructure – how will these investments shift capital priorities looking ahead?

Doing our homework on the new school year: The General Assembly will also have preliminary reports on how K-12 learning loss prevention grants were used over the summer, and interim study committee findings on educational achievement gaps and higher education funding formula.

September also brings the Average Daily Membership (ADM) count that sets state funding for local schools.

As mentioned on page 3, disrupted enrollments and college transition trends led to nearly $200 million in unspent education funding in FY2021. This September's ADM will provide a better idea whether enrollment has stabilized, along with more information on how schools are spending state and federal aid and managing any unforeseen back-to-school challenges before reevaluating K-12 funding commitments.

Closing out this review of such a historic year of revenue growth and budget management with a series of uncertainties is unsatisfying but somehow appropriate given the surprising strength of Indiana's bottom line. Two things are certain: Indiana is in an enviable fiscal position at the end of FY2021, but the historic revenue surge of the last few months isn't sustainable over time.

In this case, caution isn't a cop-out: Indiana should protect a healthy surplus as Hoosiers enter a post-COVID future that could create unanticipated opportunities for growth or put unexpected demands on the state's rainy day resources.