Budget Battle Preview

Change Required in State's Financial Course

By Tom Schuman

The numbers may vary depending on the source of the information, but there is no denying that Indiana's state government faces a substantial budget deficit. The reversal of state economic fortunes is the key issue facing the 2005 General Assembly and one of the early challenges for incoming Gov. Mitch Daniels and his administration.

How did the deficit develop? How does this shortfall compare to previous economic downturns? What are the potential solutions? How does the wildcard – a new executive branch promising a more aggressive role in all aspects of governance – impact the process? Will there be tax increases?

These questions and more are addressed by four people who have been part of the budget process for more than 30 years. They are:

Participants

- **Larry Borst,** chairman of the Senate Finance Committee since the early 1970s until his defeat in the 2004 election. Borst is currently a senior public policy consultant with Baker & Daniels law firm
- **Kevin Brinegar,** president of the Indiana Chamber of Commerce, has been involved at the Statehouse for 24 years. He was with the Legislative Services Agency and was the fiscal analyst for the Senate Finance Committee before joining the Chamber in 1992
- **Steve Johnson** served 20 years in the General Assembly, with stints on both the House Ways and Means and Senate Finance committees. He is president and CEO of the Indiana Fiscal Policy Institute
- **Pat Kiely,** president of the Indiana Manufacturers Association, was a seven-term representative before joining IMA in 1991. He was chairman of the House Ways and Means and State Budget committees

Digging the hole

The participants say that a number of factors came together to produce the current deficit situation. There were also ample warning signs, they add, that were either ignored or not fully comprehended.

Borst and Kiely were among those who sought a revised economic forecast in early 2001. Indicators such as rapidly rising unemployment claims and declining spending patterns were signs of trouble to come.

"The data flow and what people were telling the governor was different than what was the reality of the economics," Kiely states. "A lot of this could have been held back had the administration gotten control of the spending side a lot earlier. They didn't come through with a deficit reduction plan until about 18 months later."

Brinegar also recalls that time period, saying the unemployment jumps actually followed the extensive loss of the worker overtime that had become so prevalent. That, in turn, led to significant revenue losses on the personal income tax side of the revenue equation.

In addition, when the December 2000 revenue and Medicaid forecasts were being presented, there was the announcement that several hundred thousand participants had been added to the Children's Health Insurance Program (CHIP). If those numbers were being added at a time of strong business and income growth, Brinegar says trouble was sure to follow when the economy turned.

Johnson terms it a "horrendous convergence of events," citing the state's tax cuts, the downturn in the stock market and some one-time state expenditures.

Editor's Note: This discussion took place before the mid-December revenue forecast update.

Borst notes the cumulative impact of those tax cuts that went largely unnoticed at the time. Even the more straightforward signs – for the first time in history, two consecutive years of the state taking in less money than the year before – didn't prompt immediate action, but should have.

"Even after we realized the money wasn't coming in, most of us didn't see any leadership from the administration to cut back on the budget," Borst explains. "We seemed to go on with the same old budget. We may not have had any new programs, but certainly the old programs were being well funded."

"Is the new governor going to work with the legislature or is he going to tell them? I have a feeling he's going to tell them. If he does it that way, he's going to run into some resistance."

– Larry Borst
Baker & Daniels

Kiely throws in a lackluster Department of Commerce performance in failing to attract high-quality, high-wage jobs at the same rate as other states. That points to a longer-term problem that has still not been reversed.

Borst says Indiana, no matter the measure, is approximately 2% of the national gross amount. "Some years ago Indiana was 2.1% of personal income on the national level. All of a sudden in the 1990s it started slipping. We're at maybe 1.8% or 1.76%, which is a heck of a difference. It just simply means that Indiana has not kept up."

Borrow now, pay later

Overcoming past budget deficits has included tactics such as borrowing from other funds (teachers' retirement and gaming to name two), as well as payment delays to schools, universities and for local property tax relief. As a key person in putting those budgets together, Borst says everything was "fair game." In his opinion, "if there was a fund that had a surplus in it, it should be used for the best purposes, rather than increasing taxes."

All agree, however, that those adjustments must be addressed. A true analysis of the current numbers puts the operating deficit at $800 million, plus $400 million borrowed from other funds and more than $700 million in payment delays. The total comes to nearly $2 billion.

"We need to put those back on schedule to really have the state's finances back to square one," Brinegar comments. Kiely adds, "We're further down the line in this particular cycle than we have ever been without defining when we're going to reverse those payment delays."

Historically, Johnson notes that he carried the budget bill in 1982 while in the House, and in conjunction with Borst in the Senate, "We had built in enough revenue to pay that back." Johnson says there was no similar plan for repayments in the early 1990s, but that the economy came back stronger than expected.

Kiely disagrees with the use of pension funds to fill budget gaps, citing a huge unfunded liability in the teachers' retirement fund. The hole is only going to get deeper, he says.

Johnson explains the creation of the pension stabilization fund in the mid-1990s has created some difficult choices for lawmakers. The dilemma, he asserts, is "how do they go about essentially taking a long-term view and not going in and capturing too much money too early."

Borst adds, "That was established in order to hide money, to get it away from legislators and governors so it wouldn't be spent on day-to-day propositions. It's still a good idea, but I imagine whoever puts the next budget together is going to be awfully tempted just to do it one more time."

Adding to the complexity

The challenges don't end there. The experts point to additional circumstances that cloud the effort:

- A less than accurate performance in recent years in predicting state revenues. Borst calls the present system antiquated, with the need to potentially go outside the state to bring in the expertise needed.
- Opportunities exist to more effectively allocate the large amount of the budget that goes to K-12 education, but so do economic threats if school corporations fail to meet state standards and federal requirements under the No Child Left Behind Act. "How do you then go in and begin to manage that corporation?" Johnson asks. "What are the state's resources literally to go in and be able to manage a school corporation that is in dire straits?"
- In a recent count, more than half the states were facing lawsuits based on the "adequacy" of school funding. Indiana has been spared thus far, but an unpleasant result in the next budget could lead school advocates to consider such a measure, Kiely offers.
- A pending regulation on property taxes that will move the state toward annual assessments. The intent is to avoid the "sticker shock" that occurred during the most recent, often delayed reassessment and lessen the impact on the business community, which unintentionally pays a higher share of the overall property tax burden during these reassessment delays. The down side is an estimated $200 million statewide increase in property tax replacement credits over the next two years (instead of those costs being spread out over a longer period).

The Chamber advocated for the annual assessments with the focus on

"Go to the annual (property tax) adjustments, computerize this thing, take the money you would have spent on the reassessments and you've paid for your problem."

– Pat Kiely
Indiana Manufacturers Association

the long-term benefits. Brinegar cautions, however, "What they may have to do is start it the year after the next reassessment so that the sticker shock comes from the next reassessment itself, not from the first time you implement the annual adjustments."

Borst and Kiely advocate taking the next step and eliminating reassessment altogether. Borst cites the actual costs from conducting the last three reassessments increasing from $36 million to $80 million to $120 million.

"We've done absolutely nothing to prepare ourselves (for the next recession). "If it comes sooner rather than later, it's going to create a disaster for the state."

– Steve Johnson
Indiana Fiscal Policy Institute

Kiely says, "Go to the annual adjustments, computerize this thing, take the money you would have spent on the reassessments and you've paid for your problem." Borst adds, "I would go one step further, for the state to go ahead and do all the data collection, the data work and then bill back to the county the percentage and have the county pay for that."

Playing politics

Budget discussions and General Assembly actions must take into account the political realities. Meeting the short-term needs is that reality, while the long-term investments in education and economic development potentially suffer.

"There's very little thought given beyond the next 30 months that you're dealing with and that's rightly so," Borst contends. "The state is not a banker and it really doesn't need or should have a giant surplus."

Improved efficiency in meeting immediate demands could lead to increased resources for future investments. Kiely believes there still is the potential for huge savings in the operation of state government, including a fundamental change to a long-held philosophy.

"Government has been run on a base plus, people thinking they should get no less, they should be rewarded for inflation and they should get more dollars every year," he summarizes. Some people are going to view it (the Daniels approach) as negative because they're going to be held accountable for the first time in a long time. There will be some positive tension around, but that doesn't hurt anybody."

The core budget elements take up most of the state funding, Johnson points out, with little left for areas such as economic development. He expects to see innovative approaches in using local money for business development purposes, a concept Daniels advocated during the campaign.

New way of doing business

Following the election of a new governor and a new majority party in the Indiana House, few doubt that the General Assembly is in for a major change from the status quo. The unknown is how that change will impact the budget process.

Borst, who notes that Daniels promised less (and won) than anyone he recalls running for a top state or federal office, categorizes it this way. "Is the new governor going to work with the legislature or is he going to tell them? I have a feeling he's going to tell them. If he does it that way, he's going to run into some resistance."

"We need to put those (payment delays) back on schedule to really have the state's finances back to square one."

– Kevin Brinegar
Indiana Chamber of Commerce

Johnson makes a comparison to the early 1980s when Republicans last took control of the governor's office and Lt. Gov. John Mutz was given broad authority to run the Department of Commerce. The economy at that time, however, was crashing, he adds, with the Robert Orr-Mutz team creatively trying to produce any type of economic activity.

"You had a legislature that was willing to follow," Johnson claims. "In the intervening years, you've had the legislature, and in a collective sense both Republicans and Democrats, become a little more involved in terms of what they think their part is in the process. It will be very interesting to see whether they are willing to be led or whether they're going to flex their own muscles and try to deal with these changes and the concerns they will have in their own particular constituencies."

Kiely recalls a good working relationship with Orr and Mutz as House and Senate leadership would meet in the governor's office on a weekly basis. That has not been seen since, he states, with the General Assembly becoming more bold out of necessity. No matter the situation, Kiely believes the governor

has to get to know and respect the legislature.

The new House Ways & Means chair, 32-year representative Jeff Espich, will be a powerful player, Brinegar predicts. The slim Republican majority (52-48) in the House will be a factor, along with the Senate decision to split the former finance committee into two separate panels dealing with taxation and budget issues.

House Democrats will be heard, Kiely concurs, pointing out sage advice he received years ago that, "You're only in the minority if you think you are." The source of that advice was Borst.

The big question

When the curtain closes on this legislative session in late April, will tax increases be part of the equation?

Several offer that it's difficult to make that determination in late November, as work was under way at that point to determine the exact scope of the problem. In addition, the revenue and Medicaid projections, the best available data to guide the process, were being compiled.

Nevertheless, Borst asserts, "I personally don't think a tax increase is needed. There are some things that can be done within the budget." Borst says the governor has to convince all involved to give him two years to get the job done.

Kiely agrees, at least as far as the $800 million structural budget deficit is concerned. "It's a big problem, but it's not a monumental problem." The 1982 shortfall was approximately 25% of the state budget, Kiely says. The current numbers are less than 10%.

Brinegar knows the executive and legislative leaders will "do everything possible to avoid raising revenues, but I think it's going to be difficult to avoid that."

Johnson looks beyond the next two years. The growing number of external factors – federal deficits, China, terrorism – along with the lack of state action on the payment delays causes particular concern.

"We've done absolutely nothing to prepare ourselves (for the next recession)," he contends. "If it comes sooner rather than later, it's going to create a disaster for the state because we've not been able to pull ourselves back together."

Despite the problems, challenges and concerns communicated, Borst concludes, "(Daniels) has got the same aura and expectations that Dr. Bowen (Otis, Indiana governor from 1972-80) had. Dr. Bowen had that political capital, and he had no problem raising taxes. No problem at all because they believed in him. I think they will believe in Mitch too."

INFORMATION LINK

Resources: Larry Borst at (317) 237-1217

Kevin Brinegar at (317) 264-6882

Steve Johnson at (317) 237-2890

Pat Kiely at (317) 632-2474