



Indiana University Public Policy Institute

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Indiana, along with other states, faces major changes in the economic landscape. People naturally seek to address the immediate problems, but there is also a need to look into the future, to be more proactive in shaping Indiana's future. PPI has undertaken a process to develop policy recommendations for Indiana's future based on conditions in Indiana called *Policy Choices for Indiana's Future*. The primary audience includes major decision makers in Indiana in the public, private, and nonprofit sectors.

The project is focusing on current and future economic conditions in Indiana within the broader context of the Midwest, and includes three commissions, each given the task of addressing a key area for the future of Indiana: *State and Local Tax Policy*, *Education and Workforce Development*, and *Energy and the Environment*. For the purposes of this project the Midwest region is defined as Illinois, Indiana, Iowa, Michigan, Minnesota, Ohio, and Wisconsin.

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Assessing Indiana's Tax, Fiscal, and Economic Condition

Indiana's tax and fiscal policy has changed significantly over the last decade. The state sales tax rate has increased twice, corporate income taxes were simplified and recently reduced, and the method of assessments and rate at which property is taxed has been altered. Education, health services, and public safety expenditures have been the primary drivers of government outlays. Also, the state has assumed increased responsibility for funding K-12 education and the administration of welfare services. Along the way, two economic recessions have increased unemployment and dampened growth in personal income.

Having just completed a legislative budget session after the largest recession in memory, it is useful to take stock of how things have changed for the state. What can we say about the condition of government tax and fiscal policy? What are the prospects for long-term fiscal sustainability, given economic conditions and the means by which we finance government? This issue brief summarizes trends in government revenues and spending since 2000. Specifically included are (1) a timeline showing significant changes in state and local tax policy in Indiana; (2) trends in government revenue and spending, given changes to our system of taxing and spending; (3) the most recent data available on revenues and on the recently passed 2011-13 biennial Indiana state budget; and (4) an outlook on economic conditions, prospects for revenue generation, and implications of changes to federal tax and spending policy on state government.

Timeline of major changes to Indiana's tax structure

The Indiana General Assembly has made many significant changes to state and local tax legislation since 1995 (Figure 1). In 2002, the General Assembly raised several major tax rates (general sales, motor fuels, and cigarette tax rates), adjusted protocol for property assessments (based on an Indiana State Supreme Court decision in response to a challenge by the Town of St. John), increased deductions and credits for owners of homestead property, simplified the corporate tax rate to a single rate, and set limits on state spending (665 N.E.2d 965, *Ind. Tax 1996*). Also of importance are the inclusion of gaming tax revenues to the state General Fund (2003) and a shift to annual property assessments (2006).

In 2008, another major tax restructuring bill was enacted by the General Assembly, this time imposing statutory limits on the rates at which various properties are taxed (property tax caps) and increasing the sales tax rate in conjunction with the state assuming funding of K-12 education, county welfare, and public safety pensions. To pay for these items, the General Assembly phased out the Property Tax Replacement Credit and Homestead Credit programs, and also increased the state sales tax rate by a percentage point. In addition, House Enrolled Act 1478 (HEA-1478, 2008) provided several new local option income taxes for local government to offset property tax losses, including a *LOIT to Freeze Property Tax Levy*, a *LOIT for Property Tax Relief*, and a *LOIT for Public Safety*. As of 2010, 24 counties have adopted one or more of these new LOITs, providing an additional \$267 million for local units (Faulk, Kuhlman, Salimova, & Devaraj, 2011). The net effect of these changes is still manifesting itself, particularly at the local level. When examining data presented in this brief, keep in mind that policies enacted in 2002 and 2008 have had significant impacts on state revenue and spending. Changes between 2002 and 2003, and 2008 and 2009 should be interpreted in light of these measures.



Figure 1. Timeline of changes to Indiana's tax structure, 1995 - 2010

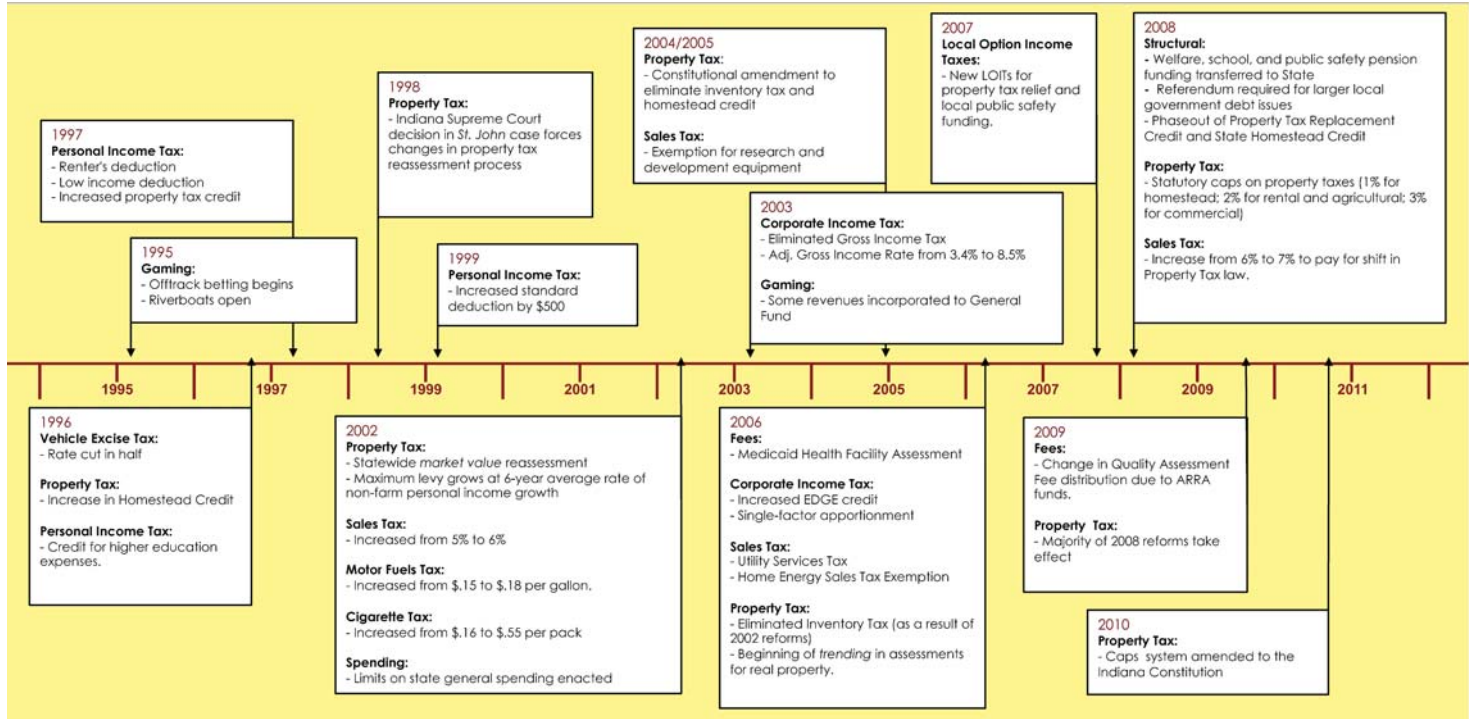


Table 1. Indiana state and local own-source revenue, budgets, and rates, adjusted for inflation, 2000 - 2010

Year	State/local revenue (\$ millions)	State/local budgets (\$ millions)	Personal income (\$ millions)	Revenue per \$1,000 income	Budgets per \$1,000 income	State population	Revenue per capita	Budgets per capita
2000	\$23,500	\$22,186	\$211,820	\$111	\$105	6,091,649	\$3,858	\$3,642
2001	23,308	22,804	211,468	110	108	6,124,967	3,805	3,723
2002	23,029	22,568	212,481	108	106	6,149,007	3,745	3,670
2003	24,278	23,029	216,520	112	106	6,181,789	3,927	3,725
2004	25,133	24,330	219,653	114	111	6,214,454	4,044	3,915
2005	25,445	23,946	218,308	117	110	6,253,120	4,069	3,829
2006	26,654	23,979	223,754	119	107	6,301,700	4,230	3,805
2007	27,514	24,871	225,732	122	110	6,346,113	4,336	3,919
2008	27,186	24,690	226,543	120	109	6,388,309	4,256	3,865
2009	23,918	23,743	222,111	108	107	6,423,113	3,724	3,697
2010	22,689	21,775	226,562	100	96	6,483,802	3,499	3,358
Annualized growth rate								
2000-08	1.8%	1.3%	0.8%	1.0%	0.5%	0.6%	1.2%	0.7%
2008-10	-8.6%	-6.1%	0.0%	-8.6%	-6.1%	0.7%	-9.3%	-6.8%
2000-10	-0.4%	-0.2%	0.7%	-1.0%	-0.9%	0.6%	-1.0%	-0.8%
Total growth rate								
2000-08	15.7%	11.3%	7.0%	8.2%	4.1%	4.9%	10.3%	6.1%
2008-10	-16.5%	-11.8%	0.0%	-16.6%	-11.8%	1.5%	-17.8%	-13.1%
2000-10	-3.5%	-1.9%	7.0%	-9.7%	-8.2%	6.4%	-9.3%	-7.8%

Notes: 2010=100

Local government actual spending not available at time of publication; appropriations used as a proxy. Revenue excludes basic grants for K-12 education, a transfer from state to local government.

Sources: Indiana State Budget Agency; Indiana Department of Local Government Finance; US Bureau of Economic Analysis; US Census Bureau



Trends in revenue and spending

Changes to Indiana tax and spending policy have impacted not only how the state and local governments operate, but how they interact. This section addresses both state- and local-level trends in revenues and spending, and how the distribution of revenues and services has changed since 2000. Unless otherwise noted, analyses are limited to own-source revenues, though state spending on K-12 education services (known as “Basic Grant” funding) is included where appropriate. At the state level, the analysis is generally limited to state General Fund items.

NOTE: Actual spending data at the local government level were not available in a consolidated format for analysis; consequently, local budgets are used as a proxy. In cases where the extent of state and local spending is presented, all data are the amounts appropriated in local budgets. In exhibits with data at the state-level only, actual spending data are presented.

Overall trends

Adjusted for inflation, Indiana governments take in and spend less than ten years ago (Table 1). The 2008 recession created an environment in which stagnant personal income growth produced a 16 percent decline in state and local revenue through 2010. Per \$1,000 income and per capita, revenue decreased faster than did appropriations from 2008 to 2010; in effect, Indiana governments were budgeting to spend more than they collected. Adjusted for inflation, the amount of revenue and spending in 2010 was at or below that of 2000 (Figure 2). A mix of federal stimulus, use of state reserves, and agencies spending less than their budgeted amounts (i.e., reversions) helped to reduce the impact of the 2008 recession on Indiana governments.

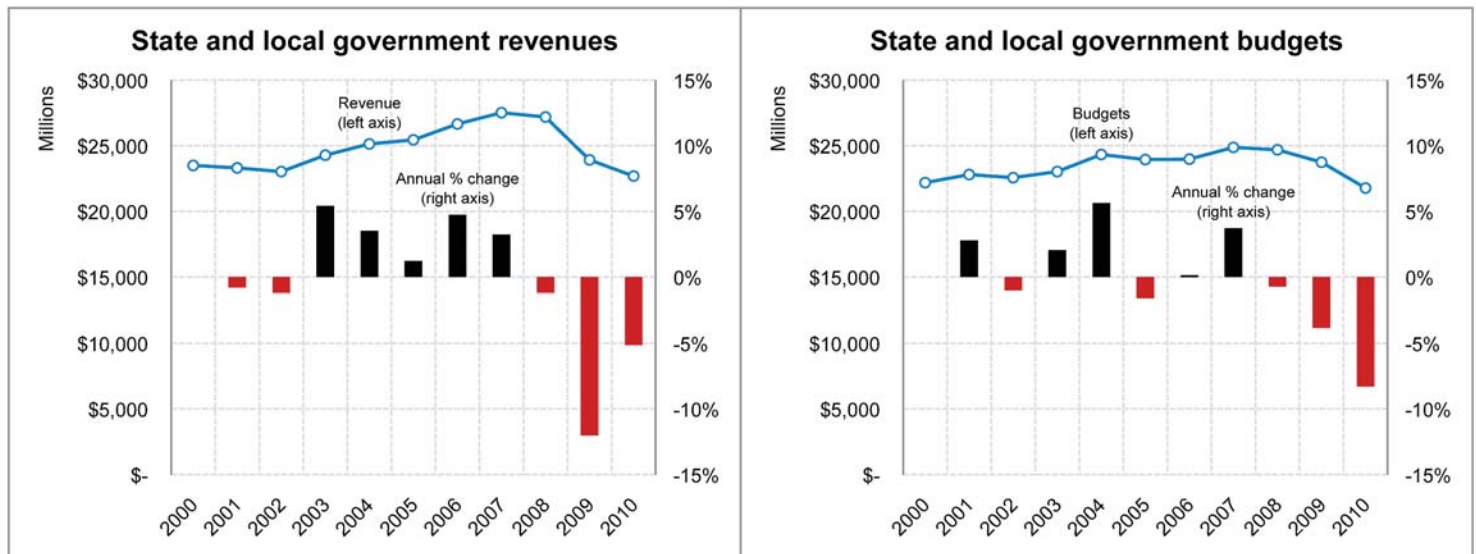
The General Assembly’s actions have changed the mix of revenues and spending for state and local government over the last ten years. Property taxes as a share of total revenue have decreased from 31 percent in 2000 to 28 percent in 2010, whereas sales tax revenues increased from 20 percent in 2000 to 26 percent in 2010. The increased adoption of local option income taxes as well as gaming tax revenue have also altered the revenue portfolio for Indiana. As a share of the total budget for services, 18 percent of total appropriations now go to health services, compared to 14 percent a decade ago. Shares of appropriations for public safety (police and fire protection) and corrections have both increased.

State trends

Sales tax revenues have been the primary source of state revenue growth since 2000 (Table 2). Note however, that these gains are primarily from policy changes rather than measurable growth in the tax base. In real 2010 dollars, sales tax revenues increased by 2.5 percent annually; however, without two percentage-point increases to the rate, total revenue would have remained roughly at 2000 levels. In general, the state revenue mix has changed with the sales tax rate increases and the increased shares of gaming taxes to the state general fund in 2003. Sales tax revenue now comprises nearly half of total state revenues, compared to 40 percent in 2000. Spending at the state level has increased primarily through funding of K-12 education and provision of health services to Medicaid and Medicare recipients.

Economic conditions and modest growth in employment and personal income created an environment in which the state has had higher expenditures than revenues for eight of the previous ten years. In aggregate, the most recent recession produced a net negative income of about \$1.6 billion from 2008-10. Individual and corporate income tax revenue streams were hardest hit, with 2009-10 declines of 12 and 31 percent, respectively. Over \$4 billion in federal stimulus funds

Figure 2. State and local revenues and operating budgets, adjusted for inflation, 2000 - 2010



Notes: 2010=100
 Revenue excludes the transfer of basic grants for school funding from the state to local governments.
 Sources: Indiana State Budget Agency; Indiana Department of Local Government Finance; US Bureau of Labor Statistics



Table 2. State government revenue and spending, adjusted for inflation, 2000 - 2010

(\$ millions)	Millions of 2010 dollars											Annualized rate of change (%)		
	FY 2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2000-08	2009-10	2000-10
Revenue														
Sales tax	\$4,624	4,539	4,559	4,945	5,450	5,538	5,653	5,657	5,759	6,254	5,915	2.8	(5.4)	2.5
Individual income tax	\$4,753	4,654	4,292	4,319	4,396	4,704	4,675	4,854	4,899	4,385	3,876	0.4	(11.6)	(2.0)
Corp. income tax	\$1,248	1,053	860	864	744	921	1,001	1,038	921	853	592	(3.7)	(30.6)	(7.2)
Gaming tax (State share)	\$-	-	-	510	694	653	638	658	590	618	680	n/a	10.0	n/a
Licenses, fees, misc.	\$953	899	845	1,071	975	953	1,078	1,072	1,080	1,038	1,125	1.6	8.4	1.7
All Other	\$72	87	105	200	345	58	404	82	122	118	130	6.8	9.9	6.0
Revenue Total	\$11,650	11,233	10,661	11,908	12,604	12,827	13,449	13,361	13,372	13,266	12,317	1.7	(7.2)	0.6
Spending														
K-12 tuition support	\$3,814	4,048	3,803	4,067	4,202	4,152	4,254	4,167	3,913	4,718	6,115	0.3	29.6	4.8
Higher education	\$1,686	1,639	1,569	1,648	1,690	1,694	1,666	1,658	1,701	1,778	1,691	0.1	(4.9)	0.0
Other education	\$1,139	1,090	911	917	672	661	858	883	928	1,033	1,021	(2.5)	(1.2)	(1.1)
Medicaid	\$1,267	1,368	1,379	1,383	1,436	1,556	1,514	1,730	2,053	1,767	1,129	6.2	(36.1)	(1.1)
Social Services	\$207	208	258	312	322	302	322	406	437	762	933	9.8	22.6	16.2
Other Health	\$728	778	784	685	648	537	516	479	450	513	419	(5.8)	(18.2)	(5.4)
Corrections	\$623	674	706	704	715	693	632	628	645	677	660	0.4	(2.5)	0.6
Property Tax Relief	\$1,396	1,502	1,467	1,646	2,863	2,392	2,347	2,321	2,228	1,171	60	6.0	n/a	(27.0)
All Other	\$1,181	1,028	888	878	835	815	826	912	1,088	1,613	1,077	(1.0)	(33.3)	(0.9)
Spending Total	\$12,041	12,335	11,766	12,241	13,382	12,802	12,935	13,186	13,443	14,030	13,105	1.4	(6.6)	0.8
SURPLUS (DEFICIT)	\$(392)	(1,102)	(1,105)	(333)	(778)	25	514	175	(71)	(765)	(788)			
Federal Stimulus (ARRA)	\$-	-	-	-	-	-	-	-	-	948	1,680			

Notes: 2010=100
ARRA = American Recovery and Reinvestment Act of 2009
Source: Indiana State Budget Agency

through 2011 (\$2.6 billion through 2010, as part of the American Recovery and Reinvestment Act) assisted in the provision of Medicaid, education services, and infrastructure improvement plans (Indiana Transparency Portal, 2011). Reversions of agency budgets went up to ten percent of total appropriations in 2009, nearly five times higher than any other year since 2000. The use of Rainy Day Funds and state transfers from the Medicaid and Tuition Reserves also acted as a countermeasure to the impact of the 2008 recession, though the Rainy Day Fund was completely exhausted by 2010. In effect, while all of these measures have left Indiana in decent fiscal shape so far, state reserves are low by long-term historical standards and will need to be increased in preparation for future economic downturns.

Local trends

Using inflation-adjusted 2010 dollars, revenues raised by local governments (including county, township, city/town, library, school, and special districts) grew by about one percent annually through 2008, driven largely by growth in property taxes and local option income tax revenue (Table 3). As noted in Figure 1, structural changes in 2008 resulted in the loss of tax revenue due to property tax caps enacted in 2008 that was partially replaced by increased state grants for K-12 education. In 2010, local property taxes and state grants to local school districts for education together made up about 72 percent of total local government revenue. In terms of rev-

enue raised directly by local governments (not from state or federal sources), local option income taxes make up about eight percent of total revenue, compared to five percent in 2000. Police and fire protection appropriations have increased most rapidly of all direct spending categories for local government since 2000.

Local option income taxes

Due to administrative lags in property and local income taxes collections, the recession is now having its greatest impact on local government revenues and budgets. The 2008 recession created a ripple effect on local tax revenues, as job losses overall, especially in manufacturing and construction, decreased taxable income and restricted improvements to properties. Less taxable income and fewer improvements to properties affected net assessed values. Since local governments set their property tax rate at the ratio of the gross levy to assessed values, a lower assessed valuation drove tax rates up in some areas. Over the last three years, local option income tax distributions have outpaced collections, resulting in negative fund balances for county governments (Figure 3). The administrative lag in local option taxes (distributions this year come from collections last year, based on income earned two years ago) makes accurate assessments of distributions relative to collections difficult. To adjust for this over-distribution, the state plans to flatline LOIT distributions through 2013 at 2011 levels, allowing collections to make up for the shortfalls.



Table 3. Local government revenue and budgets, adjusted for inflation, 2000 - 2010

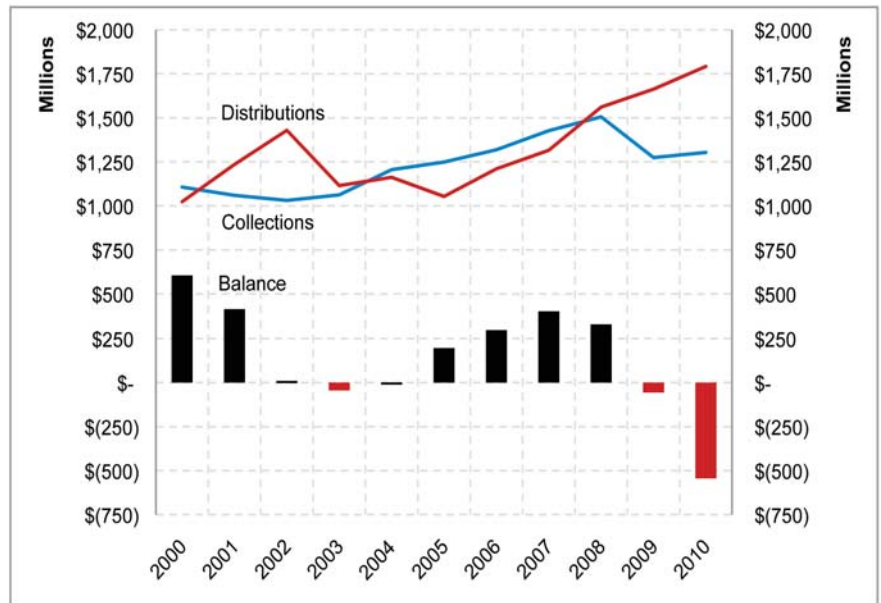
(\$ millions)	Millions of 2010 dollars											Annualized rate of change (%)		
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2000-08	2009-10	2000-10
Revenue														
Property taxes	\$7,306	7,393	7,688	8,114	8,346	8,422	8,633	8,988	8,951	6,291	6,324	2.6	0.5	(1.4)
Basic grant (schools)	\$4,025	4,141	4,234	4,225	4,194	4,184	4,074	3,966	3,827	6,303	6,148	(0.6)	(2.5)	4.3
Excise/FIT	\$399	391	391	398	404	384	376	368	352	287	275	(1.5)	(4.3)	(3.6)
Local income taxes	\$707	756	956	756	706	653	755	768	766	861	833	1.0	(3.3)	1.7
Motor vehicle highway	\$1,146	1,137	1,059	1,118	1,022	997	918	868	824	737	738	(4.0)	0.1	(4.3)
Other	\$3,439	3,536	3,333	3,102	3,072	3,159	3,441	4,029	3,746	3,213	2,941	1.1	(8.5)	(1.6)
Revenue Total	\$17,021	17,353	17,661	17,713	17,746	17,799	18,197	18,987	18,466	17,692	17,258	1.0	(2.4)	0.1
Appropriated														
General operating	\$9,802	10,111	10,348	10,482	10,668	10,442	10,286	10,544	10,343	10,285	10,010	0.7	(2.7)	0.2
Capital projects	\$1,076	1,138	1,108	1,109	1,187	1,203	1,221	1,340	1,326	1,260	1,222	2.6	(3.1)	1.3
Debt service	\$1,123	1,189	1,234	1,338	1,432	1,516	1,602	1,723	1,701	1,718	1,719	5.3	0.1	4.3
Transportation	\$658	602	572	636	627	616	645	686	682	691	643	0.5	(7.0)	(0.2)
Airport/highway	\$682	696	676	678	714	723	693	768	765	733	721	1.4	(1.6)	0.6
Police/fire	\$373	389	404	389	403	433	431	361	530	535	572	4.5	7.1	4.4
Pensions	\$240	249	262	236	261	269	280	289	273	277	235	1.6	(15.2)	(0.2)
County welfare	\$373	424	438	476	520	497	530	609	573	-	-	5.5	n/a	(100.0)
Other	\$1,623	1,798	1,339	1,297	1,796	1,683	1,789	2,164	1,790	1,560	1,446	1.2	(7.3)	(1.1)
Appropriated Total	\$15,950	16,596	16,382	16,642	17,608	17,382	17,477	18,484	17,984	17,059	16,568	1.5	(2.9)	0.4

Notes: 2010=100.
Source: Indiana Department of Local Government Finance

Effects of property tax reform

As noted above, the Indiana General Assembly enacted significant reforms to the system of property taxation in 2008. Phased in over three years, a tiered property tax cap system was approved that limits homestead property tax liability at one percent of gross assessed value (GAV), other residential and farmland at two percent of GAV, and nonresidential agricultural real property, and business personal property at three percent of GAV. In general, properties within districts with higher tax districts produce tax bills that rise above the capped limits. Taxpayers receive a circuit breaker credit for bills in excess of the cap rate (e.g., for a homestead with GAV of \$100,000, a tax bill in excess of \$1,000, or one percent of GAV, would result in a circuit breaker credit to the taxpayer). Since property tax rates are additive of all unit rates within the district (county, township, library, school, etc.), taxing districts that include city/town units tend to have higher tax rates and as such tend to have larger percentage losses of revenue from circuit breaker credits. Since local govern-

Figure 3. Local option income tax balances, adjusted for inflation, 2000 - 2010



Notes: 2010=100.
Collections includes interest on investments.
Source: Department of Local Government Finance



ments establish levies necessary to fund services, and since circuit breaker credits effectively limit the total levy for a local unit, circuit breaker credits are lost revenue for local government (DeBoer, 2011; Indiana Legislative Services Agency, 2010).

In 2009, there were \$163 million in circuit breaker credits issued to property owners (Table 4).¹ In 2010, circuit breaker losses increased drastically to \$430 million. As a share of total gross levies, circuit breaker credits represented larger losses for districts with higher tax rates, upwards of 15 percent for districts with rates over \$3 per \$100 assessed values. As discussed above, city/town governments were generally hardest hit, with nearly 12 percent of total levies lost to circuit breaker credits (Figure 4). Since city/towns impose an additional rate to the property tax rate, and since city/towns tend to have

more commercial and business property, a larger share of properties become eligible for credits.

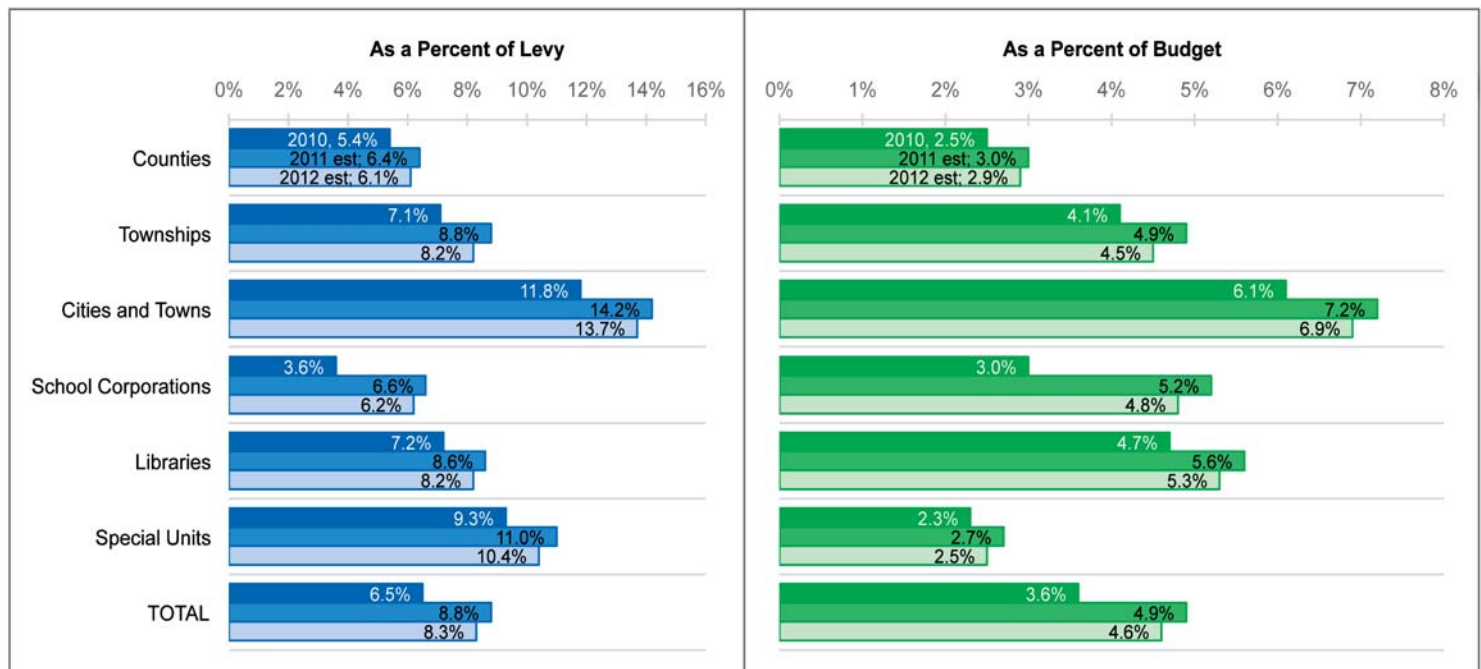
Note that proportional losses due to circuit breakers are expected to increase for 2011 and 2012 over 2010 rates; these increases are again due to the economic recession. The recession reduced personal income, leading to reductions in investments in and construction of new property. Along with foreclosures having a general negative impact on property values, assessed values for Indiana property declined. Since the property tax rate is calculated by dividing the gross levy (funds needed to support government) by the assessed valuation, decreasing assessed values means tax rates increase. Increased tax rates lead to more property eligible for credits and more credit losses. The two-year lag in the assessment

Table 4. Impact of circuit breaker credits on local government by taxing district, not adjusted for inflation, 2009 - 2010

	Tax district rate					All districts
	Under 2%	2 - 2.9%	3 - 3.9%	4 - 4.9%	5% and over	
Count of tax districts						
2009	1,131	626	144	34	4	1,939
2010	1,113	623	161	50	6	1,953
Gross levy (thousands)						
2009	\$1,871,102	\$2,792,503	\$742,244	\$339,536	\$232,599	\$5,977,985
2010	\$1,888,393	\$2,717,773	\$841,198	\$380,724	\$277,463	\$6,105,550
Circuit breaker credits (thousands)						
2009	\$205	\$21,170	\$42,257	\$40,700	\$58,938	\$163,270
2010	\$3,653	\$145,592	\$124,385	\$65,287	\$91,270	\$430,186
Credits as % levy						
2009	0.01%	0.76%	5.69%	11.99%	25.34%	2.73%
2010	0.19%	5.36%	14.79%	17.15%	32.89%	7.05%

Source: Indiana Department of Local Government Finance

Figure 4. Circuit breaker credits as a percent of levy and budget by local government unit type, 2010 - 2012



Note: Data exclude TIF allocations within Redevelopment Commission unit type.
Source: Indiana Legislative Services Agency, using data from Indiana Dept of Local Government Finance

¹Note that the property tax cap system was phased in over several years, with 2009 rates of 1.5 percent for homesteads, 2.5 percent for other residential and farmland property, and 3.5 percent for other real property and personal property. In 2010, the cap limits were reduced to 1 percent, 2 percent, and 3 percent, respectively. Consequently, 2009 circuit breaker credits generally will be lower than for 2010 and beyond because lower cap rates mean that more properties are eligible for credits.



Per instructions from the Governor, major appropriation categories were flatlined to 2011 levels for fiscal years 2012 and 2013. The 2013 budget for Indiana state government is smaller than the 2010 budget. This difference is in current dollars; to adjust for projected inflation makes the difference even more significant. The expected net result of constrained spending and modest revenue growth is a return to surplus in 2013. Government fund balances as a percent of operating revenue are expected to increase.

Prospects for Indiana's economy

Compared to previous recessions, a larger share of jobs has been lost with this one. Durable goods manufacturing and construction were hit particularly hard and have failed to recover since the recession began. A lack of sustained growth in income and in key economic sectors has compounding effects in terms of government revenues and economic vitality, specifically in constrained personal income, consumption, investments, and new construction of homes. This also means less investment and improvements to existing homes and property (as well as stagnant investment in business property), so that assessed valuations will likely grow slower than they would otherwise.

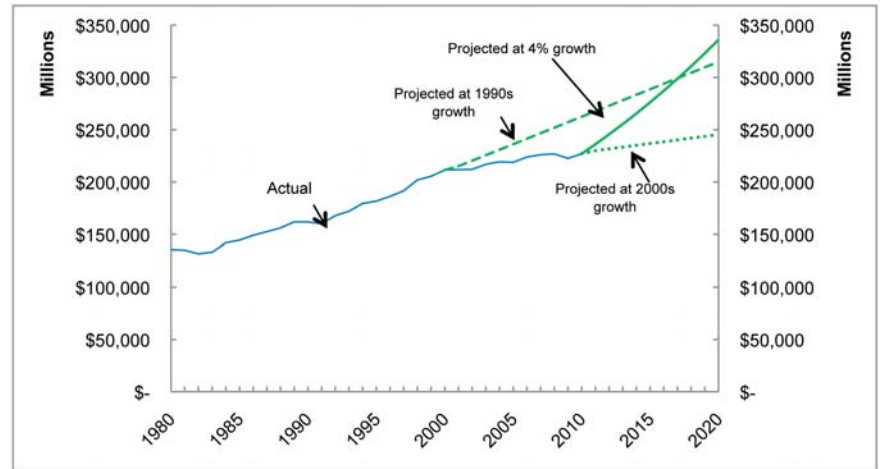
What can the state expect for the next decade? In terms of personal income, important since Indiana governments are relatively more reliant on income taxes than before, state forecasts predict growth of about four percent annually over the next two to three years. This rate exceeds the growth over the last decade (Figure 5). Estimates of personal income growth depend heavily on economic conditions, so a sustained period of economic expansion and jobs creation will need to occur to continue the growth pattern of the last 18 months.

In addition, the baby boom generation is set to start its retirement phase over the next decade. What this means is fewer people in the workforce, which by extension means less potential for robust growth in personal income. These retirees will consume different services than younger generations, and many of these services are not taxed in Indiana. Spending on health services, retirement programs, Medicare, etc., are likely to increase as our population ages.

The impact of federal tax and debt restructuring could be a significant factor in future budget sessions. While it is currently unknown what that impact will be, it is reasonable to expect reductions in federal funds,

especially in entitlement programs. Medicaid funding in particular presents a challenge to Indiana. A recent projection of Medicaid costs from federal healthcare reform shows that Indiana can expect four percent growth annually in Medicaid costs and nearly 50 percent in total from 2011 to 2020 (Milliman, Inc., 2010). The other potential impact is in income tax restructuring. The extent to which Indiana's base of income taxation is affected by any future changes remains to be seen. Regardless, Indiana should expect federal funds to decline.

Figure 5. Indiana personal income, adjusted for inflation, 1980 - 2010 and projections to 2020



Note: 2010=100
Source: Author's calculations from data provided by US Bureau of Labor Statistics and US Bureau of Economic Analysis

Conclusion

Changes to Indiana's tax and spending structure since 2000 have had a major effect on how the state finances its public services. We are now more reliant on income taxes (80 percent of total state revenues come from the sales and personal income tax), and by extension more susceptible to business cycles. While state revenues have largely rebounded, the impact of the recession is still manifesting itself at the local level in the form of increased circuit breaker losses and stagnant local option income tax growth. Spending on Medicaid, other health services, and primary and higher education will likely put greater pressure on revenue to keep up. Constrained spending in other areas have left us in a fiscal position that is better than most states, but changes to federal policy and to economic conditions locally have the potential to create real issues for the state. In addition, the state should periodically reevaluate its spending position on areas critical to our economy, such as education and infrastructure. Changes in these areas could require a rethinking of the adequacy of local revenues to meet the needs of the state.

Resources

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