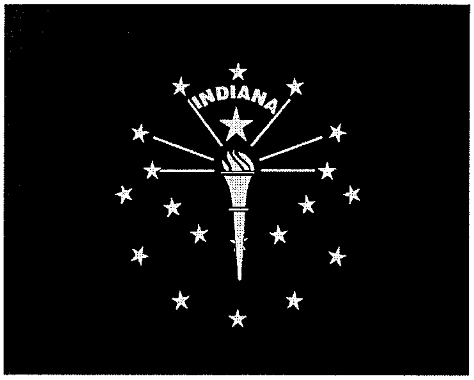

IACIR White Paper #4

Fiscal Centralization of Indiana State and Local Government

by

Alfred Tat-Kei Ho
Research Associate

and

Daniel Mullins
Director of Governmental Finance Research

Center for Urban Policy and the Environment
Indiana University School of Public and Environmental Affairs

March 1997

Indiana Advisory Commission on Intergovernmental Relations
342 North Senate Avenue
Indianapolis, IN 46204-1708

Fiscal Centralization of Indiana State and Local Government

Introduction

The 1980s was a decade of fiscal devolution—the federal government decentralized more responsibilities to state and local governments and reduced some levels of and at the same time. In the nation as a whole, intergovernmental transfers from the federal government (in constant 1987 dollars) to state and local governments decreased from $130.7 billion in 1980 to $121.2 billion in 1990.[1] As a result of the change, many states experienced structural shifts in the allocation of resources between state and local governments. In general, more centralization at the state level has occurred.

The changes in the fiscal structure have several implications. Higher fiscal centralization at the state level helps to reduce levels of fiscal stress for local governments. The problem of revenue generation is relieved because the state government has a broader tax base than local governments. Also, state revenues, mainly from sales and income taxes, are more income elastic than local sources of revenues, such as property tax. As the economy grows and the demand for public services increases, state revenues increase in an automatic fashion and will be able to respond to the increased demand. With more state subsidies, localities will see less of a need to raise property taxes. This may reduce unnecessary tax competition between localities and the potential of under-providing public services because of the hesitation to raise local revenues.

Changes in fiscal structure also have equity implications. State revenues, such as income taxes, are more progressive than local revenues, such as property taxes. When the state assumes a larger burden for financing public services, the provision of public services becomes more progressive. In addition, state funding can be used to subsidize poorer districts and reduce interjurisdictional inequity. Nonetheless, fiscal centralization has some trade-offs. Localities may lose autonomy and flexibility because state funding may carry mandatory spending requirements. Also, state requirements may override local preferences of public services and public resources may not be spent in the best manner.

This paper analyzes how the fiscal structure of the state and local governments in Indiana has evolved during the past decade and compares the trend in Indiana to other states in the midwest as well as to the national average.[2] The first section analyzes the direct spending of state and local governments - i.e. spending to other jurisdictions excluding intergovernmental grants. An examination of indirect spending (through intergovernmental grants) will follow. Then we will examine the revenue structure and its consistency with expenditure responsibilities. Finally, the implications of the findings for state and local policy makers will be submitted in the conclusion.

A Trend of Direct Expenditure Centralization. Between 1980 and 1993, the direct expenditures of both the state and local governments in Indiana significantly increased. Real per-capita expenditures of the state government (in constant 1987 dollars) increased from $708 in 1980 to $1,294 in 1993. Real per-capita spending of local governments also increased from $1,112 to $1,537 in the same period (see Figure 1). The pace of growth for state spending, however, was significantly faster that the pace of local government spending after 1984. The average annual increase of state real per-capita spending was 6.9 percent between 1984 and 1993, compared to only 3.0 percent for local governments.

As a result of the rapid increase in state expenditures, the general spending of the state and local sectors has become more centralized in Indiana, which is measured as the ratio of state spending to the total spending in the state and local sector. The overall degree of centralization in the state is higher than average in the midwest and has become closer to the national average. For instance, in 1980, the Indiana state government was responsible for 38 percent of the total spending in the state and local sectors, compared to a 35 percent average in the midwest and a 46 percent national average. In 1993, the state spending rose to 46 percent, compared to 42 percent in the midwest and 48 percent nationally (see Figure 2).

Rising Burden of State Welfare Spending

The major reason for the increased centralization is the dramatic growth of direct state welfare spending in the past decade. Due to the explosive growth in Medicaid and the broadening of eligibilities for various welfare programs, the state government has been required to allocate more resources to welfare spending. Between 1980 and 1993, real state government per-capita welfare spending (in constant 1987 dollars) increased from $118 to $436, representing average annual growth of 10.6 percent. In the same period, real per-capita welfare spending by local governments remained almost unchanged: the amount was $68 in 1993 compared to $71 in 1980. By 1993, the state government was responsible for 86.6 percent of all welfare spending at the state and local levels in Indiana, compared to only 65 percent in 1980. Figure 3 shows that Indiana has rapidly approached the level of welfare spending centralization experienced in the rest of the midwest and the nation.

Stable Structure in Other Direct Spending

In other major spending categories, the changes that Indiana has experienced have not been as dramatic. For instance, the state share of direct health and hospital expenditures remained relatively constant at 40 percent. The state share of spending in direct elementary and secondary education, higher education, highway, police, and correction also has remained stable over the past decade (see Table 1).

Indirect Spending by State

Indirect spending is an intergovernmental transfer from one government to another to finance the latter's spending responsibilities. While it is true that Indiana state government has not taken up more direct responsibilities in most spending items, the state can indirectly bear more or less burden through changes in indirect spending for local governments. An interesting example is elementary and secondary education which comprises about 70 percent of state transfers to local governments in Indiana. In 1985, Indiana state government transferred $1.9 billion (in constant 1987 dollars) to local governments for education spending. The amount increased to $2.1 billion in 1990 and $2.4 billion in 1993. However, the increase in transfers was not sufficient to cover the growth in local education spending. As a result, the ratio of state transfers to local education spending actually went down from 66 percent in 1985 to 61 percent in 1993 (see Table 2).

In general, the state's indirect contribution to local spending (via intergovernmental transfers) declined from 42 percent in 1985 to 39 percent in 1993. In areas other than education, the state's indirect share of local spending declined from 22 percent in 1985 to 20 percent in 1993. The reduction was not due to an actual decrease in the amount of state transfers to localities; rather, it was a result of the rapid increase in local spending, financed increasingly by local tax payers. A similar trend can also be found in other midwest states. However, the national trend was more stable.

A Slight Trend of Centralization in Revenue

General revenue, which includes all government revenue except liquor stores revenue, insurance trust revenue, and utility revenue, is a commonly used measure of government revenue. Between 1984 and 1993, Indiana state government's real per-capita general revenues (in constant 1987 dollars) increased at an annual rate of 4.1 percent, from $1,337 to $1,919. Real per-capita general revenues of local governments also increased, albeit at a lesser annual rate of 2.8 percent, from $1,244 to $1,599 during the same period.

As a result, there was a slight trend toward revenue centralization (see Figure 4). Compared to the average trend in the midwest, Indiana had a more centralized revenue structure, but the degree of centralization is still slightly lower than the national average.

The increase in Indiana's revenue centralization was caused to a great extent by the increase of federal transfers to the state. Of the total own-source revenue of the state and local sectors, which excludes all intergovernmental transfers such as grants-in-aid and reimbursements between governments, the state government continued to comprise about 60 percent. The tax share of the state government also remained at 66 to 67 percent throughout the 1980s but dropped to 63 percent in 1993.

Centralization in Federal Transfers

Although the national trend of federal transfers to state and local governments was decreasing during the 1980s, federal transfers to Indiana's state government increased, mainly because of the transfers in various welfare and health programs. In 1980, the state government only received 73 percent of total federal transfers to the state and local sector. By 1993, the proportion had increased to 93 percent. In 1993, federal transfers comprised 27.6 percent of state general revenues, compared to only 22.8 percent in 1985.

Other Changes in the Revenue Structure

The Indiana state government also relied more heavily on charges, fees, and miscellaneous revenues to support its increasing spending responsibilities. These categories of revenue comprised 20.4 percent of the state general revenues in 1993, compared to 16 percent in 1985. Local governments, on the other hand, continued to rely primarily on property tax revenue and state transfers. Property tax revenue consistently comprised about 30 percent of the total local general revenues, while state transfers comprised about 37 percent in the 1980s and the early 1990s.**Error! Reference source not found.Error! Reference source not found.**

Conclusion

Our results show that the direct expenditures of the state and local governments in Indiana have become more centralized at the state level. This is mainly due to the growth in state welfare expenditures. Compared to the average of the midwestern states, Indiana is relatively more centralized in its fiscal structure.

Theories of public finance suggest that if a public service has cross-jurisdictional impact on other communities, a higher level of government should be responsible for providing it. Indiana seems to be following this principle. Public services that have high externalities, such as welfare, highways, and higher education, remain the responsibilities of the state.

The limited analysis in this paper cannot determine fully whether or not Indiana's fiscal structure is equitable. However, the finding that Indiana has higher reliance on state revenues (which tend to be more progressive) to finance local services may indicate that the progressivity of local finance has improved slightly.

Furthermore, the federal fiscal devolution during the 1980s did not affect Indiana significantly. The fiscal structure remained relatively stable. The increasing burden of welfare spending was financed through federal transfers and localities did not see any significant reduction in state transfers.

However, several future concerns should be addressed. Indiana's government revenue is more sensitive to economic changes because the state's major revenue sources are federal transfers, income taxes, and sales taxes. While it is desirable to have an automatic increase of revenue to finance public services when the economy is growing, the structure may lead to a more severe revenue decrease when the economy declines. The stability of revenue will be affected more significantly because of its reliance on income and sale taxes. Another concern is that if the federal government reduces its welfare transfers to the states and decentralizes more responsibilities to the state and local sectors, fiscal stress on the state government will be intensified. Indiana eventually may need to consider some structural shifts of responsibilities that many states have already experienced, such as significant reduction of state transfers to localities and shifting of direct spending responsibilities to localities. Whether Indiana is ready for this changing environment is an open question.

Notes

[1] All government finance data are from the Bureau of Census, *Government Finance,* various years. Population data are from the U.S. Department of Commerce, *Statistical Abstract of the United States*, various years. The implicit price deflators for state and local governments are from the Department of Commerce, *Survey of Current Business*, various years.

[2] Midwest states refer to Illinois, Indiana, Iowa, Michigan, Minnesota, Missouri, Ohio, and Wisconsin.