What does the State overpayment of local income taxes mean to local governments?

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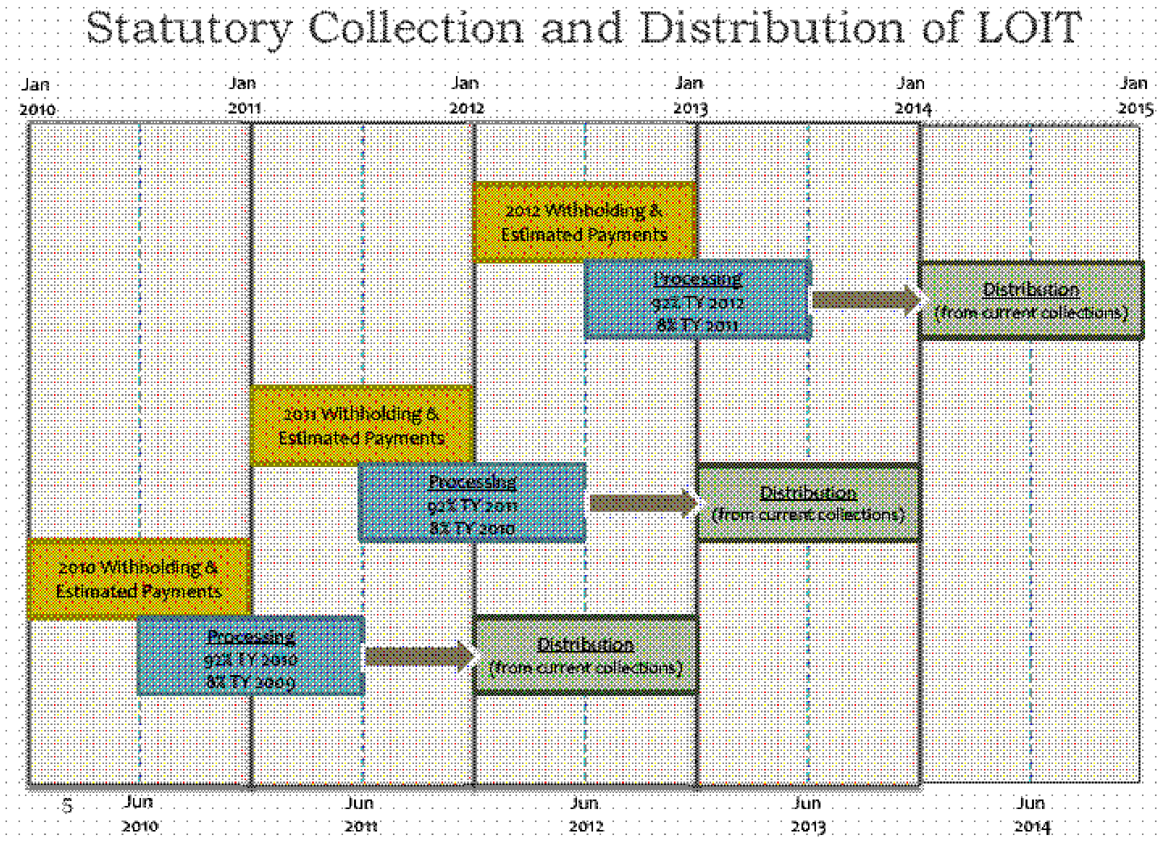
According to the State of Indiana, local units of government were overpaid for distributions of various local income taxes in 2009 and 2010 and will be again in 2011.

The details are laid out in Section 95 of the budget bill (HB1001) currently before the Indiana General Assembly. The amount certified for distribution of local taxes to counties for fiscal years 2009 through 2011 is $609,700,000 more than the taxes collected. To make up for that, the bill directs the State Budget Agency to reduce distributions in 2012, 2013 and 2014 by $408,276,000.

This surprising development leaves everyone wondering how it happened. In the simplest terms, three factors contributed to the overpayment:

- Timing of collections, certification and distribution
- Budget Agency statutory limitations and
- Severe economic downturn

The chart below illustrates the timing and statutory limitations factors. Withholding and other payments of 2010 local income taxes took place during 2010. They are processed in the second half of 2010 and the first half of 2011, then certified. The distribution of 2010 taxes will not happen until 2012, and those payments will be made using current tax collections in 2012. This process repeats every year.



When times are good and tax revenues are increasing, this system seems to work. But when income tax revenues decline as they have in the past few years, the third factor of severe economic downturn comes into play.

It appears that approximately 60% of counties have either a negative local income tax balance or close to it at the end of 2009. We don't yet know what the counties' balances or deficits will be for 2010 and 2011.

What does it mean for your local governmental unit?

If your governmental unit is in a county that will have reduced distributions in 2012 through 2014, you need to begin planning right away. The reductions:

- Will put even more pressure on your budget in a time when many local governments are already struggling,
- May cause higher property tax rates if you are using income tax as a replacement for property tax and
- May cause additional property taxes reductions due to the Circuit Breaker tax caps if your property tax rates must increase.

You should be especially concerned if you have pledged income taxes to repay debt. To avoid default closely examine your debt obligations to ensure you can still meet them. If your bond repayments are also backed up by property taxes, it may force a new levy of property taxes, which could then increase your loses to property tax caps. These situations can be extremely complex.

Counties that normally received a supplemental distribution of local income taxes will not receive these distributions while their certified distribution is reduced.

The reduced local income tax distributions in 2012-2014 will force many local governments to make difficult decisions about budgets and be creative in funding services.

We have seen hopeful signs of economic recovery in 2011 with increased employment that should produce higher revenue from local income taxes. Due to the three-year process to get that revenue back to your local government, you won't feel that relief at the local level for several years. If your local income tax distributions are reduced to make up for the overpayment, it will be at least 2015 before you can expect a rebound in this revenue source.

Umbaugh is an independent financial advisor to governmental units in the Midwest. For more information, visit www.umbaugh.com.