The ‘AAA’ Issuer Default Rating (IDR) reflects Indiana’s low long-term liability burden and strong operating profile including a commitment to structural budget balance and rapid restoration of fiscal flexibility during economic expansions. Cyclical declines can be challenging, with an above-average susceptibility of state revenues to weakness during recessions.

Key Rating Drivers

Economic Resource Base: Despite ongoing diversification, Indiana’s economy remains highly dependent on manufacturing. The state is prone to large swings in conjunction with national business cycles and is also likely to see slower overall growth than the nation. Despite the manufacturing concentration, Indiana’s overall economic profile is solid, with jobs growth slightly ahead of the national trend since the Great Recession and education and health services becoming nearly as important as manufacturing.

Revenue Framework (‘aa’ factor assessment): Fitch Ratings expects Indiana’s revenues — primarily income and sales taxes — will continue to reflect the depth and breadth of the economy, but also its slower pace of growth. The state has complete legal control over its revenues.

Expenditure Framework (‘aaa’ factor assessment): The state maintains ample expenditure flexibility with a low burden of carrying costs for liabilities and the broad expense-cutting ability common to most U.S. states. Also, as with most states, Medicaid remains a key expense driver but one that Fitch expects to remain manageable.

Long-Term Liability Burden (‘aaa’ factor assessment): Indiana’s long-term liability burden is just below the median for states and is well managed. Since establishment of the Indiana Finance Authority in 2005, debt issuance and management have been centralized. The state issues debt infrequently, has been active in the public-private partnership (PPP) market, and also relies on pay-as-you-go capital funding. The burden of unfunded pensions is higher than the debt burden, but manageable. The closed Teacher’s pre-1996 account utilizes a dedicated Pension Stabilization Fund to manage growth of annual contributions for the plan.

Operating Performance (‘aa’ factor assessment): Indiana remains extremely well-positioned to deal with economic downturns, with very strong gap-closing capacity in the form of ample budgetary reserves, the state’s control over revenues and spending and a demonstrated willingness to take timely budgetary action. The state tends to rely on its significant expenditure control to deal with budgetary stress. As revenues recover, Indiana restores many of those cuts and focuses on reserve restoration.

Rating Sensitivities

Fundamental Credit Characteristics: The state’s ratings are sensitive to shifts in fundamental credit characteristics, including Indiana’s manufacturing-centered economic profile, proactive and conservative financial management, and very manageable long-term liabilities.

Appropriation-Backed Bonds; TIFIA Loan: Ratings for Indiana’s appropriation-backed debt, including a loan with the federal Transportation Infrastructure Finance and Innovation Act (TIFIA) program, are sensitive to changes in the state’s ‘AAA’ IDR, to which they are linked.
Indiana, State of (IN)
Scenario Analysis

Analyst Interpretation of Scenario Results:

Indiana’s ability to respond to cyclical downturns rests with its superior budget flexibility. Conservative fiscal practices and a somewhat concentrated, but still diverse, economy provide sufficient resources to the state to gradually restore fiscal flexibility once utilized. Indiana typically responds to budgetary stress with spending restraint and use of budgetary reserves. After a budget is enacted, the budget agency has significant statutory authority to administer the budget and scale back spending as needed, allowing the state to be responsive to changing conditions.

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch’s downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. For further details, please see Fitch’s US Tax-Supported Rating Criteria.
Credit Profile

Revenue Framework

Indiana primarily relies on its sales and use tax and individual income tax for general operating revenues. Together, they account for 80%–90% of general fund revenues. The sales and use tax has gradually become more important and this trend will likely continue given personal income tax reductions enacted into law several years ago that are being phased in.

Historical revenue growth, adjusted for the estimated impact of policy changes, has been essentially flat on a real basis over the last 10 years. Sharp declines during the recession offset strong gains in the years leading into it. Since then, revenue growth has generally been slow. Fitch anticipates the long-term trend for revenue growth will be in line with historical performance. Indiana has no legal limitations on its independent ability to raise revenues through base broadenings, rate increases, or the assessment of new taxes or fees.

Expenditure Framework

Education is the dominant spending item for Indiana given that the state essentially fully funds basic education costs for grades K–12. Local education aid consumes roughly one-half of general fund expenditures annually. Medicaid is the next largest area of spending for the state and the most rapidly growing one. Between 2009 and 2015, Medicaid spending grew between 8% and 9% on an average annual basis while overall general fund expenditures increased at a 2.6% average annual rate.

Spending growth, absent policy actions, will likely be slightly ahead of revenue growth driven primarily by Medicaid, requiring regular budget measures to ensure ongoing balance. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. In other major areas of spending such as education, Indiana is more able to adjust the trajectory of growth since it does not retain responsibility for direct service delivery. This is true even for education spending as the state appropriates money to local school districts rather than operating any schools itself.

Indiana retains ample expenditure flexibility. While Medicaid costs are somewhat beyond the state's ability to materially change given federal requirements for the program, the state's carrying costs for liabilities are minimal. Like most states, Indiana's operating budget (outside of Medicaid) goes largely towards funding of services rather than direct service delivery allowing the state to shift costs to lower levels of government in times of fiscal stress.

Long-Term Liability Burden

Indiana maintains a modest long-term liability burden that should remain very manageable. Per Fitch's October 2015 state pension update report, the state's total net tax-supported debt and unfunded pension liabilities of $15 billion made up just 5.71% of 2014 personal income compared to the 50-state median of 5.8%.

Debt is limited to capital needs and the state is not a regular issuer. GO bonds are prohibited under state law, so Indiana has a long history of using appropriation-backed bonds to meet its capital borrowing demands. The state has been a leader in utilizing PPPs, particularly for transportation needs. The largest of these projects use an availability-payment structure with payments derived from state appropriations. Fitch incorporates estimates for the outstanding related project debt on these PPPs in its assessment of long-term liabilities. While the total
amounts are substantial and account for approximately one-third of total net tax-supported debt, overall debt levels remain very modest.

The state maintains close control over its pension system, with all but one small system under the oversight of the Indiana Public Retirement System (INPRS). The Public Employees’ Retirement Fund (PERF) and the Indiana Teachers’ Retirement Funds (TRF) are the state’s primary retirement systems. The TRF includes a pay-as-you-go pre-1996 account (closed to new members) that is supported by a substantial reserve fund (Pension Stabilization Fund) meant to smooth annual growth in state contributions to support benefits.

**Operating Performance**

Indiana’s ability to respond to cyclical downturns rests with its superior budget flexibility. Conservative fiscal practices and a somewhat concentrated, but still diverse, economy provide sufficient resources to the state to gradually restore fiscal flexibility once utilized. Indiana typically responds to budgetary stress with spending restraint and use of budgetary reserves. After a budget is enacted, the budget agency has significant statutory authority to administer the budget and scale back spending as needed, allowing the state to be responsive to changing conditions.

As revenues recover in economic expansions, the state works toward restoring prior year cuts and rebuilding reserves. By fiscal 2012, the state had essentially reached its statutory cap for budgetary reserves (12.5% of operating revenues in the final year of each biennium); since then, excess funds have been refunded to taxpayers, directed towards pay-as-you-go capital needs, or used to defease debt. The bulk of the reserves is in the form of unrestricted general fund balance with smaller portions in a Medicaid reserve, the rainy day fund, and a tuition reserve for grades K−12 education. Education funding has also been increased in recent budgets, particularly in the current fiscal 2015–2017 biennial budget, after recessionary cutbacks.

**Current Developments**

Indiana ended fiscal 2015 with another reported operating surplus (a modest $210.4 million, or 1.4% of operating revenues), even as general fund revenues fell just short of the forecast. The state, as it regularly does, utilized spending reversions to bring down expenditures midyear as revenue collections showed signs of modest weakness relative to the forecast.

Based on the December 2015 revenue forecast technical committee projection, the state forecasts fiscal 2016 operating revenues will be essentially flat versus the prior year ($68 million, or 0.4%, increase). Earlier in the fiscal year, the governor implemented a 3% executive agency spending reversion (excluding higher education) to ensure budgetary balance in light of the tepid growth expectations. Given its continued prudent budget management Fitch expects the state will end the current year in structural balance with stable reserves. Revenue through April is in line with the December forecast, with slight overperformance in individual and corporate income tax collections offsetting sales and use tax weakness.
The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2016 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Telecopier: (212) 908-0606, (212) 908-0501. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed. The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, securities laws of any particular jurisdiction, or any other laws. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.