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With Nebraska facing a $1.2 billion shortfall through FY21[1], figuring out how to close it will be one of biggest challenges for the 2017 legislature. In order to prepare for the budget debate ahead, OpenSky has prepared three policy briefs to help inform the discussion. The first policy brief examines how previous large shortfalls were addressed, a topic that will be the focus of our January 6th policy symposium. The second brief will explore the contribution of past revenue measures to the current shortfall. The third and final brief will discuss recent reports that highlight future budget uncertainty as additional factors to be taken into consideration as the legislature begins its work.

This first policy brief examines how previous large shortfalls were addressed, and implications for the current shortfall.

Nebraska did not cut its way out of previous large shortfalls

Only a handful of Nebraska's current legislators were in office when the state faced a shortfall of this magnitude. Therefore, looking back at the past two large shortfalls can provide some valuable lessons. Both the shortfall that occurred in the early 2000's and the one that lawmakers faced in 2009-11 continued to grow over a three-year period, and both ended up lasting two biennia. Neither were addressed solely by budget cuts and fund transfers.

Budget cuts, transfers and revenue increases helped bridge early 2000s shortfall

Following the recession of the early 2000s, Nebraska experienced a large budget shortfall that grew several times and prompted two special legislative sessions. The Legislature ultimately addressed the shortfall with a $1.5 billion mix of budget reductions, fund transfers and new revenues. Budget reductions during this time included cuts to K-12 funding, funding for construction projects, Medicaid and higher education funding.

Lawmakers also increased revenue by partially rolling back income tax cuts[2] that were passed in 1997, increasing the cigarette tax by 30 cents per pack, increasing the state sales tax from 5 percent to 5.5 percent, increasing alcoholic beverage excise taxes and expanding the sales tax to more services. These tax increases[3] -- which generated about $654 million[4] in new revenue -- were initially proposed as temporary but later were made permanent[5] in order to avoid large cuts to vital services.

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[1] Nebraska Legislature, "General Fund Financial Status," downloaded from http://www.nebraskalegislature.gov/FloorDocs/Current/PDF/Budget/status.pdf on Dec. 28, 2016.
[2] LB 401 (1997)
[3] LB 1085 (2002)
[4] Nebraska Legislature, "State of Nebraska FY 2003-04 / FY 2004-05 Biennial Budget," downloaded from at http://www.legislature.ne.gov/pdf/reports/fiscal/2003budget_0910.pdf on Dec. 28, 2016. Pages 12-14. Includes 4-year (FY02-03 and FY04-05) revenue impact to Financial Status as a result of LB 905 (2002), LB 1085 (2002), LB 947 (2002), and LB 759 (2003).
[5] LB 759 (2003) made the tax increases in LB 1085 permanent.

Stimulus funds allowed lawmakers to avoid tax increases after the Great Recession

In the aftermath of the Great Recession, the state again experienced a large shortfall that grew multiple times and prompted lawmakers to call one special session. Actions taken to close the shortfall after the Great Recession included a $1.4 billion mix of budget reductions, fund transfers and use of federal stimulus funds. The influx of $556 million in federal stimulus dollars during the Great Recession allowed lawmakers to avoid raising taxes like they did in the early 2000s.

During this downturn, lawmakers cut state aid to cities and counties, K-12 education funding, corrections funding and support for Medicaid and several public assistance programs. Nebraska lawmakers are still dealing with ramifications of these measures as the cuts to corrections contributed to highly-publicized problems with our state's prison system, and the reductions in K-12 funding and aid to cities and counties increased our reliance on property taxes to fund local services.

Our current scenario

While a weakened farm economy has certainly contributed to Nebraska's decline in revenue, unlike the two prior shortfalls, our current shortfall does not come on the heels of a national recession. A recent report from the U.S. Government Accountability Office[6] notes that the budget shortfalls presently facing Nebraska and many other states might be part of a long-term trend of shortfalls associated with costs related to our aging population. GAO specifically notes that increased costs of providing health services and increased pension costs for aging Americans are a key factor in the growing fiscal gap, which GAO notes could carry on for about 40 years.

And while the Legislature has a healthier cash reserve to rely on than in prior years,[7] several of the cuts that were made in previous shortfalls cannot be made again, such as state aid to cities and counties. Furthermore, as will be discussed in the second brief in this series, tax cuts made over the last decade costing about $754 million in FY16 alone according to the Legislative Fiscal Office, are certainly contributing to the current shortfall.

And rather than receive federal assistance, as we did following the Great Recession, we could actually see a reduction in federal funding depending on actions taken at the federal level. For example, should Congress act to cut federal income taxes, the state

[6] U.S. Government Accountability Office, "State and Local Governments Fiscal Outlook, 2016 Update," downloaded from http://www.gao.gov/assets/690/681506.pdf on Dec. 21, 2016.

[7] The Cash Reserve Fund is currently estimated to end FY19 with a balance that is 13.3% of General Fund revenue. This compares to 2.4 percent at the end of FY03 and 8.9 percent at the end of FY11. Report of the November 2016 Tax Rate Review Committee, downloaded from http://www.legislature.ne.gov/pdf/reports/fiscal/taxratereview_2016.pdf, pp. 7-8

would likely experience a reduction in state income tax revenue collections, due to the coupling of the state income tax to the federal income tax. Also, if federal funding for programs like Medicaid and education are cut, that will compound the current shortfall and the impact to education, health care and other services.

Conclusion

In the past, Nebraska lawmakers chose to rely on more than just budget cuts and transfers to protect investments in schools, public safety, roads and other vital services. Prior large shortfalls proved to be longer than anticipated and the recent GAO report and state fiscal data suggest that our current shortfall could continue beyond this biennium, and is in fact estimated to continue at least through FY21.

There also are important differences about the current shortfall that pose new and unprecedented challenges. While declines in the farm economy are certainly contributing to the current shortfall, previous shortfalls were clearly tied to a national recession. This could mean that our current shortfall may be rooted in more structural issues such as costs associated with an aging population as well as the ongoing effects of previous tax cuts. This could cause our current shortfall to persist much longer than the two previous deficits. Furthermore, there is uncertainty regarding federal changes, and those changes could have major and long-lasting effects on our state, schools and economy, as well.

With all of this in mind, a prudent big-picture approach to our current shortfall that considers structural causes and solutions is likely to be much more effective than trying to apply a quick fix using only funding cuts and cash fund transfers.