OpenSky Policy Institute

EDITOR'S NOTE: As our state and nation continue to confront the COVID-19 pandemic, state fiscal and federal policies will play key roles in ensuring the physical and economic health of Nebraska and its residents. OpenSky Policy Institute staff will be continuously analyzing state and federal policies that impact Nebraskans during this national emergency. This analysis is part of that effort. You can access more of our pandemic-response policy analysis here. We also remind you that OpenSky staff are working remotely during the pandemic response. Remote contact information for staff members can be found here.

The COVID-19 pandemic has brought with it many challenges for local governments. As states have scrambled to test, quarantine and treat residents, an enormous challenge has loomed in the background: keeping state budgets whole. To illustrate this issue, Moody's has projected that states will see at least a 10% reduction in revenues, with the average reduction between 15% and 25%. Economists are struggling to predict the recovery as the sudden shock from the pandemic is unlike anything we have seen before.

In recent briefs, we've looked at what the minimum Moody's projection -- a 10% reduction amounting to about $500 million -- would look like, and here we consider additional scenarios to show how the state budget might look if revenues come in different than Moody's minimum. Three scenarios follow, showing how hypothetical revenue reductions -- based on the most recent projections for the U.S. economy -- would play out during the current and next biennium. (See hypothetical methodology note at the end of the brief.)

Scenarios in which state revenue reductions are greater than 10% are particularly bleak for the current biennium

There has been a lot of speculation as to how the economic downturn from the COVID-19 crisis will play out. We've discussed how national economic models present the fallout and have recent data indicating the severity of the pandemic: the U.S. economy contracted 4.8% in the first quarter of 2020, its steepest decline in over a decade.[1] This number is particularly troubling as it only captures half a month of COVID-19; a more significant contraction in the second quarter of 2020 is almost certain.[2] The following scenarios assume no additional appropriations by the Legislature this biennium not covered by the federal CARES Act and that the mid-biennium adjustment bills -- LB 1008 and LB 1009 -- do not pass. The scenarios reflect Moody's recent report

[1] Lincoln Journal Star, "US Economy Shrinks by 4.8 percent in first quarter, biggest decline since 2008," accessed at https://journalstar.com/news/national/us-economy-shrinks-by-4-8-percent-in-first-quarter-biggest-decline-since-2008/article_dccd118d-01aa-5662-9e5b-60df16e6352e.html#utm_source=journalstar.com&utm_campaign=%2Fnewsletter-templates%2Fbreaking&utm_medium=PostUp&utm_content=d512d32d38754e91ff751746ca2c97a7eddefda0 on April 30, 2020.

[2] The New York Times, "Worst Economy in a Decade. What's Next? 'Worst in Our Lifetime.' Accessed at https://www.nytimes.com/2020/04/29/business/economy/us-gdp.html on April 30, 2020.

highlighting significant general fund revenue losses to states which could mean some experiencing roughly twice the level of fiscal shock experienced under the Great Recession.[3]

The likely best-case scenario, a relatively short but deep contraction of the economy with a quick rebound -- often referred to as a 'V-shaped' recovery -- shows Nebraska faring relatively well. This potential recovery projects revenue reductions equal to 20% in each of the first six months of the pandemic -- April through September -- and ends the current biennium with an estimated shortfall of about $200 million (see sidebar for assumptions made).

A deeper recession, however, is where the numbers appear more dire for Nebraska. The second scenario presented -- one longer than the more-optimistic 'V-shape' recovery -- could leave the state with a shortfall nearing $450 million at the end of the current biennium. This assumes revenue reductions of 20% in the final quarter of FY 20 and 10% over the entirety of FY 21. The cash reserve would have enough money to cover a shortfall of this magnitude as the pre-COVID-19 balance was $510 million.[4] However, it's a shortfall of even greater magnitude that becomes a problem for not only the current biennium, but also the next.

The worst-case scenario presented -- 20% revenue reductions in the final quarter of FY 20 and 15% in all of FY 21 -- would leave a shortfall nearing $700 million at the end of the current biennium, more than the balance in the cash reserve. A shortfall of this magnitude -- or even worse -- would mean significant cuts to the mid-biennium budget, ravaging state agencies that have set budgets (e.g., schools that have already hired teachers for the fall), and leave the state in a dire fiscal position heading into the next biennium.

A shortfall in the current biennium could mean damaging cuts to education and other vital services

Mid-biennium cuts are particularly difficult for state agencies to absorb because they have already approved and partially executed their budget. For example, mid-biennium cuts could mean schools having to cut non-certificated staff, defer maintenance or even borrow money to cover their obligations, as teachers are already under contract for fall classes. Cuts would also mean significant uncertainty for the University of Nebraska system that has already begun to see effects from the pandemic and strain the already overcrowded and understaffed correctional facilities, which are relying on a transfer in

[3] Moody's Analytics, "Stress Testing States: COVID-19," accessed at https://www.economy.com/economicview/analysis/379097/StressTesting-States-COVID19 on May 5, 2020.
[4] Nebraska Legislature, "March 24, 2020 General Fund Financial Status," accessed at https://nebraskalegislature.gov/FloorDocs/Current/PDF/Budget/status.pdf on April 29, 2020.

FY 21 from the Cash Reserve Fund to add additional beds.[5] Requiring agencies to cut budgets mid-biennium could easily translate to a reduction in services.

A robust cash reserve fund is exactly the prescription for economic hardships like COVID-19

Nebraska entered the pandemic with a balance equal to nearly 11% of yearly general fund state revenues in the rainy-day fund, which is below the recommended level of 16%.[6] The Tax Foundation ranked Nebraska thirteenth best for rainy-day funds as a percentage of general fund expenditures, with a balance nearly 40% greater than the U.S. median.[7] The state also recently learned that the pandemic response appropriations taken from the Cash Reserve Fund in March can be covered by federal CARES Act funding, which means the state will be able to maintain its pre-pandemic cash reserve balance. While the fund has enough money to cover a shortfall this biennium in the best case and midpoint scenario, it certainly does not have enough to cover a shortfall if we end up near the worse end of the recession spectrum.

The cash reserve will be integral in determining the state's fiscal health as we finish the current biennium and enter the next, because the scope of the state's fallout will in part depend on whether the fund is large enough to cover shortfalls. Should the cash reserve, however, not have enough money to cover a shortfall -- either this biennium or the next -- it would precipitate spending cuts in the absence of new revenue or federal support, hurting Nebraskans who need state services the most. And beyond hurting Nebraskans, a depleted reserve could spell trouble for longer-term state fiscal health, particularly if the recovery is slow.

Outlook for next biennium even more precarious than current biennium

As the three scenarios show, the state could see a shortfall this biennium that runs the gamut from manageable to downright bad, all depending on the depth and duration of the pandemic and state and federal policy responses. One thing that is clear, however, is even the best case scenario will likely mean a shortfall rather than the surplus that was projected in the current biennium and revenues far below pre-COVID-19 estimates for the next biennium.[8] How the state ends the current biennium will have a significant impact on the next, so the smaller the shortfall, the better.

[5] Note: the current pre-COVID-19 balance in the Cash Reserve Fund is $510 million, but the unobligated balance is $455 million as the legislature authorized a transfer of $54.7 million from the fund in FY 21 for capital construction. Nebraska Legislature, "State of Nebraska FY 2019-20/FY 2020-21 Biennial Budget As Enacted in the 106th Legislature First Session," accessed at https://nebraskalegislature.gov/pdf/reports/fiscal/2019budget.pdf on April 29, 2020.

[6] Nebraska Legislature, "Appropriations Committee Budget Proposal, Mid-Biennium Budget Adjustments FY 2019-20 and FY 2020-21," accessed at https://www.nebraskalegislature.gov/pdf/reports/fiscal/2020proposal.pdf on May 6, 2020.

[7] Tax Foundation, "State Rainy Day Funds and the COVID-19 Crisis," accessed at https://taxfoundation.org/state-rainy-day-funds-covid-19/ on April 28, 2020.

[8] Nebraska Legislature, "March 24, 2020 General Fund Financial Status," accessed at https://nebraskalegislature.gov/FloorDocs/Current/PDF/Budget/status.pdf on April 29, 2020.

Projections from the Congressional Budget Office indicate that the U.S. economy will not return to pre-pandemic output until at least 2022 and have sustained unemployment through 2021 of more than 10%, which complicates the state fiscal outlook for the next biennium.[9] Given those economic projections, it's not difficult to imagine a scenario where revenues continue to decline. If, for example, FY 22 revenues were to decline at the 5% level experienced after The Great Recession and hold steady for FY 23, state revenues could come in between $1.7 billion and $2.7 billion below projected expenditures in the next biennium depending on which of the three scenarios is considered. Coupled with an anemic economic rebound, lingering high unemployment and the potential for continued depressed revenues, it's clear that the next biennium could be worse than the current.

Conclusion

The recovery scenarios presented by economists leave little doubt that Nebraska faces a long road ahead, but the extent of any shortfalls will depend on the severity and duration of the economic fallout caused by COVID-19. Nebraska is in a better position than most states to absorb the impending fiscal strain, but questions remain as to whether the Cash Reserve Fund and economic recovery will mean the state escapes relatively unscathed, or if we face a choice between cuts to vital services and finding new sources of revenue.

Methodology notes

Appropriations are held to current law in these scenarios; it assumes all general fund transfers out remain as in the Legislature's March 24 General Fund Financial Status but that no additional spending is done this biennium. We assume the mid-biennium budget adjustments (LB 1008 and LB 1009) as currently introduced do not pass because the Legislature's funding priorities have changed and lawmakers will not have the surplus originally projected.

In calculating the revenue reductions for FY 20 in each scenario -- from which we start each analysis -- we took FY 20 receipts to date (July 2019-March 2020) and added to it the actual FY 19 receipts for April 2019-June 2019 (FY 19 Q4) less 20%, the assumed percentage FY 20 revenues will be reduced in Q4. Actual FY 20 Q4 revenue is likely to be down more than 20% due to the extension of the income tax filing deadline; however, for this analysis, we assume those revenues are received in FY 20 as it won't change the revenue impact for the biennium.

[9] Congressional Budget Office, "CBO's Current Projections of Output, Employment, and Interest Rates and a Preliminary Look at Federal Deficits for 2020 and 2021," accessed at https://www.cbo.gov/publication/56335 on April 29, 2020.