2023 Nebraska Budget Stress Test

Prepared by the Legislative Fiscal Office

2023 Budget Stress Test Report

Summary

Neb. Rev. Stat. sec. 50-419 requires the Legislative Fiscal Analyst to prepare a budget stress test comparing estimated future revenue to and expenditure from major funds and tax types under various potential economic conditions. This report analyzes revenues to the General Fund from the major sources of taxes (sales and use, individual income tax, corporate income tax, and miscellaneous tax) in different economic scenarios, expenditures from the General Fund most directly tied to an economic downturn, and the inventory of buffers available in these scenarios. The Legislative Fiscal Office (LFO) analyzes the total General Funds at risk, to revenues and expenditures, for the four-year period of FY2023-24 to FY2026-27.

LFO finds the inventory of buffers exceed the total General Funds at risk under the two economic downturn scenarios evaluated.

Scenarios

For purposes of determining the General Fund revenue risk in this budget stress test, LFO utilizes three scenarios from Moody's Analytics: baseline, slower-trend growth, and next-cycle recession. The assumptions for the scenarios are discussed in the following sections.

Baseline

This scenario includes the following key assumptions:

- Monetary policy by the Federal Reserve is done tightening and will ease in 2024.
- There is a brief, two-week government shut-down in the 4th quarter of 2023, which leads to a 0.25% reduction in GDP, which reverses in the following quarter.
- The economy reaches full-employment with an unemployment rate around 3.5%, a 62.5% labor force participation rate, and a prime-age employment-to-population ratio in the range of 80%.
- Bank failures in 2023 are not a sign of a broader problem in the financial system and do not undermine economic growth.
- The forecast for oil prices increases slightly in the near term due to the conflict in Israel, but no other impacts of this conflict are assumed.

This scenario, by definition, has a 50% probability that the economy will perform better than this and a 50% probability that it will perform worse. Key national variables for this scenario are shown in the following table.

Baseline	Percentage Change				
	2023	2024	2025	2026	2027
GDP growth	2.1	1.3	1.8	2.4	2.5
Employment growth	2.3	0.6	0.4	0.4	0.4
Unemployment rate	3.7	4.1	4.2	4.1	4.1
CPI	4.1	2.7	2.2	2.1	2.0
Fed Funds Rate	5.0	5.1	4.2	3.1	2.7
S&P 500 growth	4.0	8.3	3.4	5.1	6.2

Slower-Trend Growth

This scenario assumes slower economic growth than the baseline for the remainder of 2023 and through 2024, underperforming indefinitely. This scenario includes the following key assumptions:

- Despite the recent deal in Congress, the risk of an extended federal shutdown rises again, causing consumer and business sentiment to weaken.
- Elevated interest rates slow credit-sensitive spending more and longer than expected.
- Recent bank failures weaken consumer confidence and cause banks to tighten lending standards.
- Worries grow that the conflict in Israel leads to a wider conflict.
- The conflict in Ukraine and tensions between China and Taiwan persist longer than expected.

Key national variables for this scenario are shown in the following table.

Slower-Trend Growth	Percentage Change				
	2023	2024	2025	2026	2027
GDP growth	2.1	0.8	1.0	1.8	2.0
Employment growth	2.1	-0.9	0.0	0.5	0.6
Unemployment rate	3.7	5.0	5.1	4.8	4.5
CPI	4.1	2.6	1.9	1.7	1.8
Fed Funds Rate	5.0	4.8	4.0	3.0	2.6
S&P 500 growth	3.9	5.5	2.2	3.8	4.5

Next-Cycle Recession

This scenario assumes the Federal Reserve’s tight policy response to inflation leads to recession. This scenario includes the following key assumptions:

- Despite the recent deal in Congress, the risk of an extended federal shutdown increases, reducing consumer and business confidence.
- The Fed’s efforts to resolve recent bank failures are not successful at restoring consumer confidence and banks tighten lending standards more than expected.
- The conflict in Israel raises concerns that it will lead to a wider conflict.
- Russia’s invasion of Ukraine persists. Further, China threatens to block the Taiwan Strait, limiting the supply of chips from Taiwan. This lowers consumer and business confidence.
- Despite the slower growth in the economy than in the baseline in the fourth quarter of 2023, the Fed keeps the fed funds rate at the baseline target range of 5.25% to 5.5% during that time because of concerns about inflation.
- The combination of the increased risk of an extended federal shutdown, declining confidence, concerns about previous bank failures, and still-elevated interest rates sends the U.S. economy into recession in the first quarter of 2024. The rising unemployment rate causes the stock market to fall sharply.
- The economy returns to full employment in mid-2026.

Key national variables for this scenario are shown in the following table.

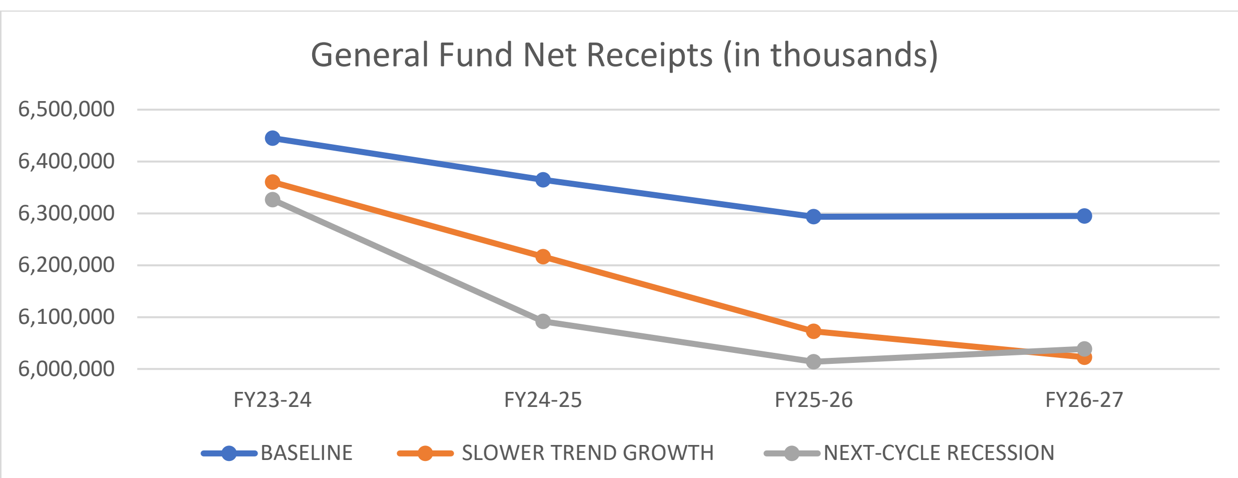
Next-Cycle Recession	Percentage Change				
	2023	2024	2025	2026	2027
GDP growth	2.1	-0.5	1.9	3.4	2.9
Employment growth	2.1	-2.0	0.6	1.1	0.4
Unemployment rate	3.7	5.6	5.0	4.2	4.1
CPI	4.1	2.2	1.9	2.1	2.0
Fed Funds Rate	5.0	3.9	3.6	3.1	2.7
S&P 500 growth	3.6	-11.9	6.9	20.7	8.8

Revenue

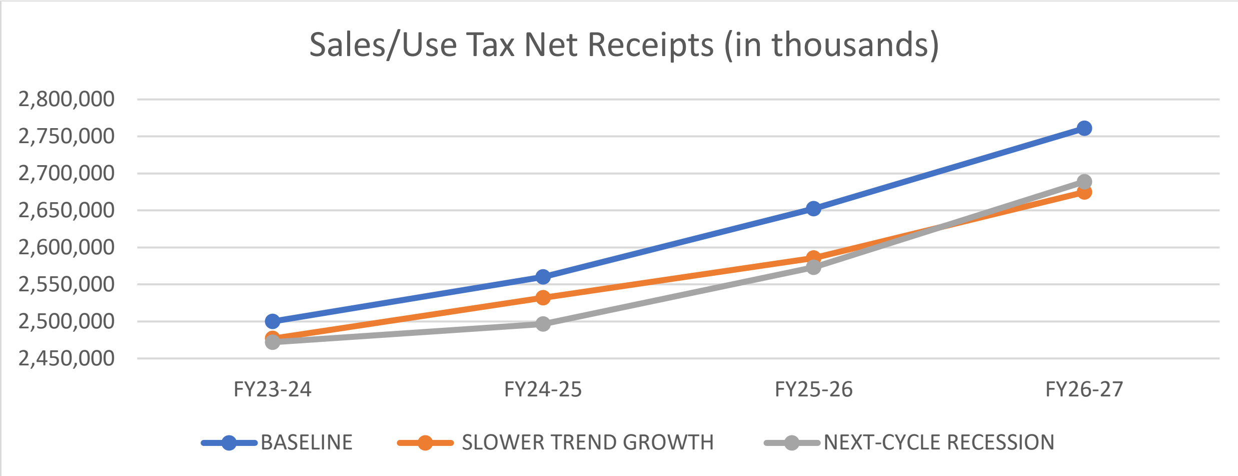
To compare the estimated revenue credited to the General Fund, the estimated General Fund revenue forecast from October 2023, set by the Nebraska Economic Forecasting Advisory Board, is utilized for FY2023-24 and FY2024-25 as the baseline forecast, and LFO estimated the baseline forecast for FY2025-26 and FY2026-27 using Moody's baseline assumptions. LFO forecast revenue under the Slower-Trend Growth and Next-Cycle Recession scenarios for the four year period as well, utilizing Moody's assumptions for each scenario. Revenue at risk is shown for each scenario as the difference between estimated tax collected in the baseline and estimated tax collected in each scenario. The net receipts are lower in each scenario evaluated for each fiscal year than in the baseline forecast. The cumulative revenue at risk over the four-year period is $726.2 million in the Slower-Trend Growth scenario and $928.0 million in the Next-Cycle Recession scenario.

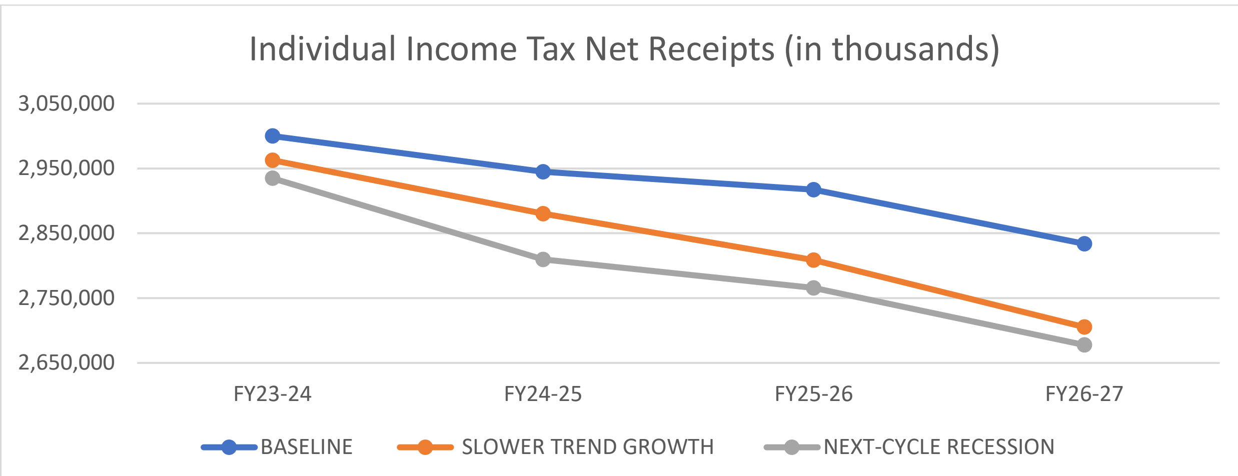
Total General Fund Revenue at Risk by Type of Tax FY2023-24 to FY2026-27 (in thousands)		
Scenario	**Slower-Trend Growth**	**Next-Cycle Recession**
Sales/Use Tax	204,206	242,519
Ind. Income Tax	339,327	507,969
Corp. Income Tax	158,530	145,995
Misc. Tax	24,147	31,471
Total	**726,210**	**927,955**

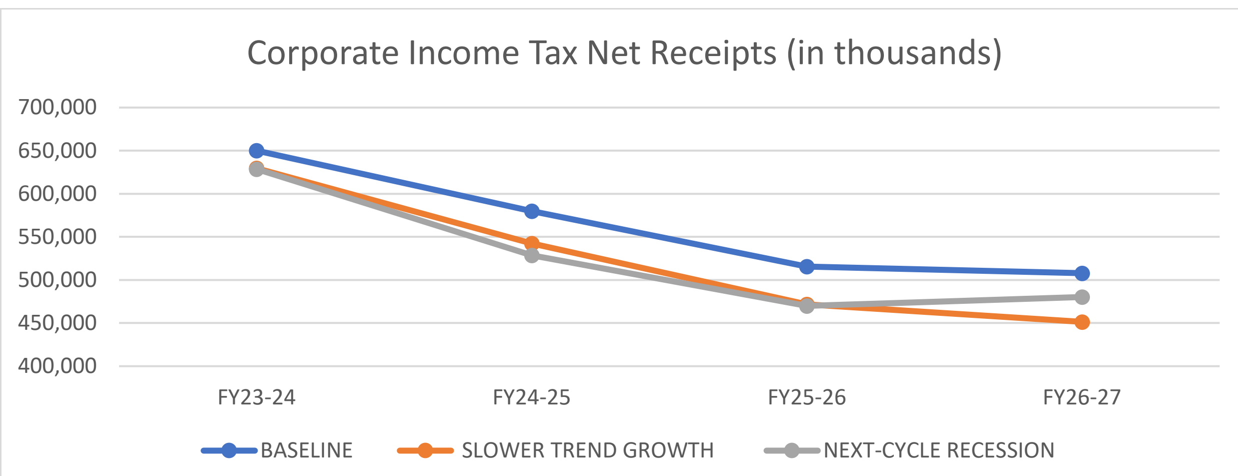
The following shows the estimated General Fund revenue by fiscal year in the three scenarios.

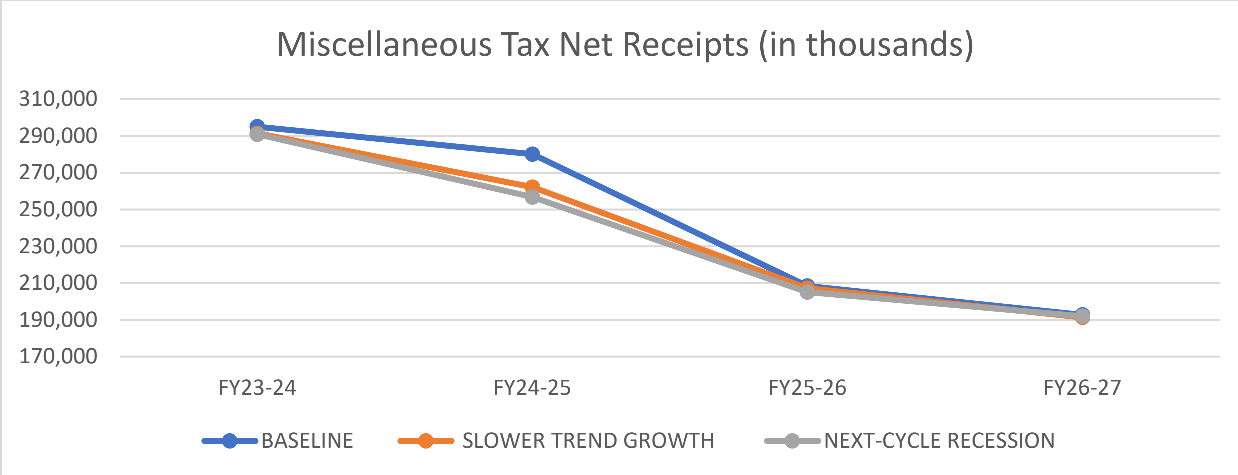


In addition to General Fund net receipts, the following charts display estimated net receipts by type of tax by fiscal year.









Expenditures

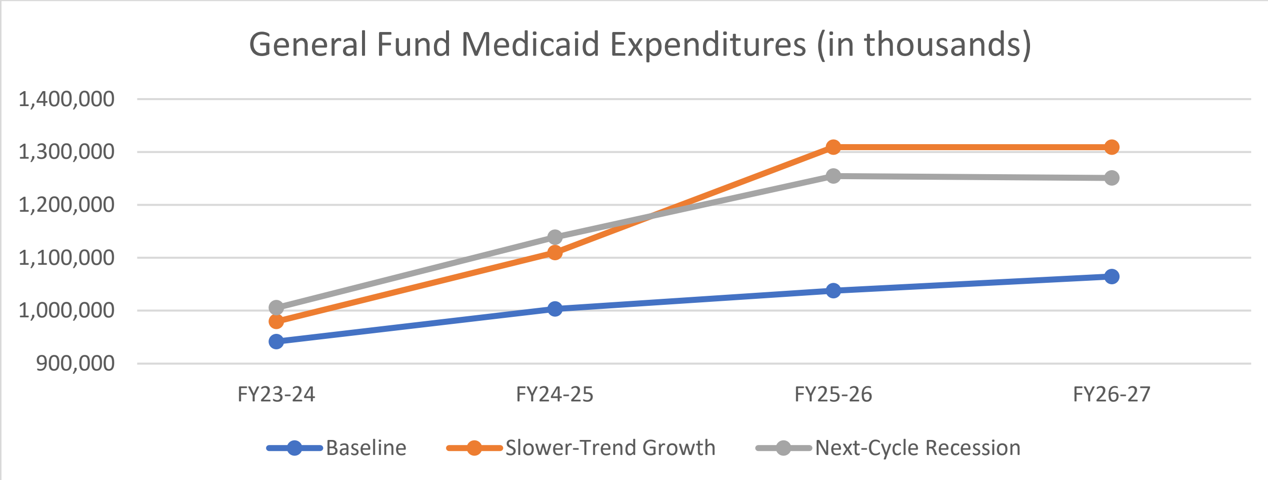
For purposes of this report, LFO focuses on the risk to state General Fund expenditures due to changes in the economic variables for each of the three scenarios previously described. In evaluating state expenditures in previous economic downturns, the expenditure displaying the most likely risk for increases directly related to those economic conditions was the Medical Assistance Program (Medicaid).

Expenditures pursuant to Medicaid are from state and federal sources. The federal portion is determined by the Federal Medical Assistance Percentage (FMAP), which is based on a state's per capita income as compared to national per capita income. The minimum FMAP by law is 50%. For purposes of this analysis, the FMAP for FY2023-24 and FY2024-25, used in all three scenarios, is calculated based on the actual federal fiscal year FMAP for Nebraska for the corresponding federal fiscal years. The calculated FMAP is 58.42% in FY2023-24 and 57.79% in FY2024-25. In the baseline scenario, the calculated FMAP of 57.52% is used in FY2025-26 and FY2026-27. In the Slower-Trend Growth and Next-Cycle Recession scenarios, the FMAP used in FY2025-26 and FY2026-27 is 50%, which is used to illustrate the compounded effect of a slowing economy and the lagged impact of a decline in the FMAP. In all scenarios, the federal contribution for Medicaid expansion enrollees is 90% and there are no anticipated changes to this percent.

For this expense, LFO forecasted Medicaid enrollment in traditional Medicaid and Medicaid expansion categories in each year based on assumptions related to each economic scenario. Historical increases were used to calculate a per-member, per-month (PMPM) rate for each enrollment category, which was then applied to the enrollment forecast to get estimated aggregate expenditures. Increased expenditures for both categories were aggregated to capture total expense risk. Total expenditures at risk over the four-year period are $661.2 million in the Slower-Trend Growth scenario and $602.6 million in the Next-Cycle Recession scenario.

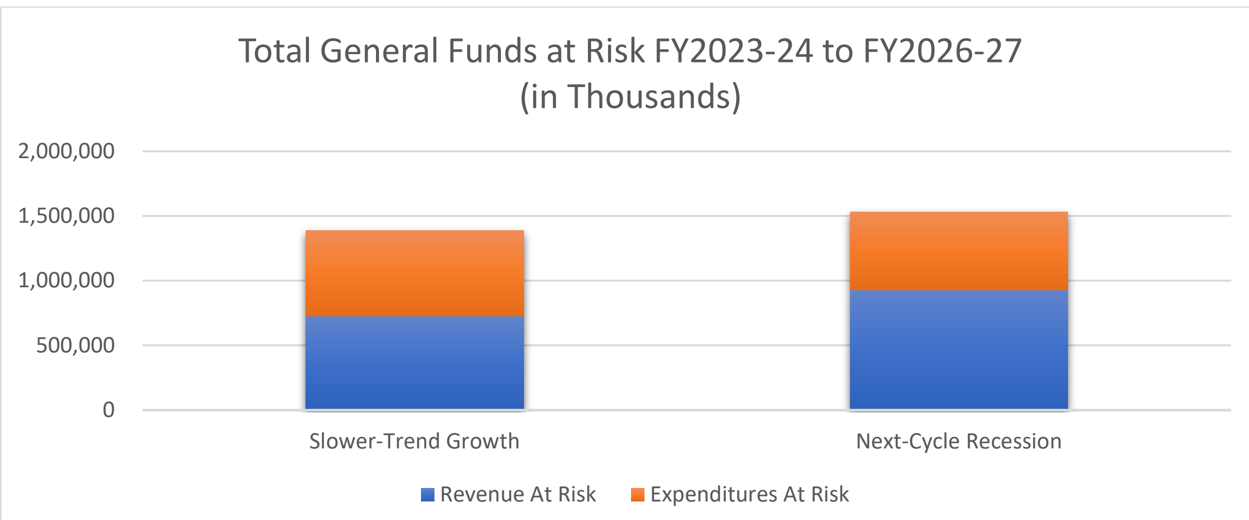
Total General Fund Expenditures at Risk FY2023-24 to FY2026-27 (in thousands)		
Scenario	**Slower-Trend Growth**	**Next-Cycle Recession**
Total	**661,235**	**602,597**

The following shows the estimated General Fund Medicaid expenditures by fiscal year in the three scenarios.



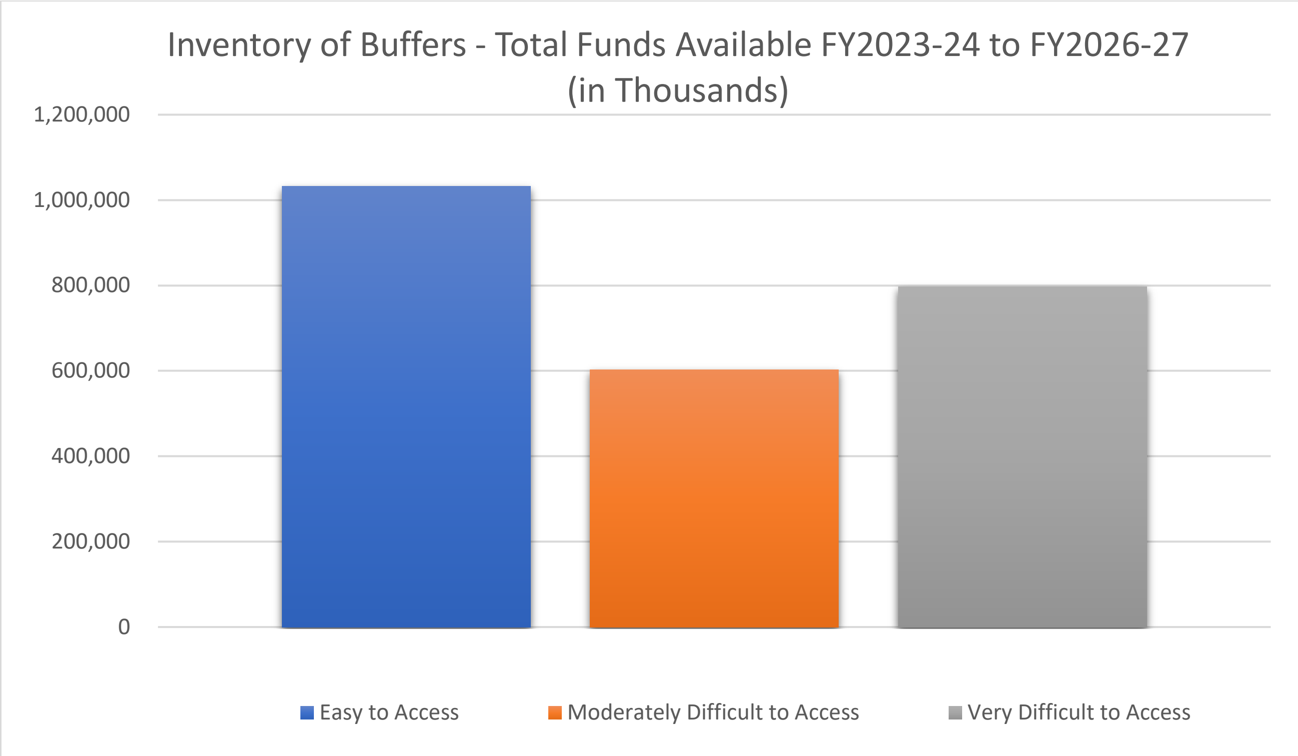
Total Funds at Risk

In combining the total revenue at risk and the total expenditures at risk, over the four-year period, there is estimated to be total funds at risk of $1.387 billion under the Slower-Trend Growth scenario and $1.53 billion under the Next-Cycle Recession scenario.



Inventory of Buffers

In order to address a potential shortfall in the General Fund, several solutions are available. Firstly, the Cash Reserve Fund has a projected unobligated balance at the end of the four-year period of $740 million. As of the November 2023 Tax Rate Review Committee Report, the General Fund has a projected unobligated balance above the minimum reserve of $379 million for the FY2023-24/FY2024-25 biennium. State cash funds with unobligated balances are also available to supplement the General Fund and have been used in past economic downturns to address a General Fund shortfall. LFO has analyzed these available budget reserves by ease of access over the four-year time period, and the totals are shown in the following table. It should be noted that some state funds are not included here due to limitation of access for the purpose of stabilizing the General Fund in times of economic downturn.



Easy to access funds total $1.03 billion over the four-year period, moderately difficult to access funds total $603 million over the four-year period, and very difficult to access funds total $797 million over the four-year period. Funds in the easy or moderately difficult to access categories total $1.63 billion, which exceeds the total value at risk in either scenario. The state has an estimated maximum total funds available of $2.43 billion over the four-year period in case of an economic downturn. This amount exceeds the estimated value at risk in the Slower-Trend Growth scenario by $1.044 billion and the Next-Cycle Recession scenario by $901 million.