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To: Luke Teater and Meredith Moon, Governor’s Office of State Planning and Budgeting
From: Sheanna Gomes, The Pew Charitable Trusts
Date: August 20, 2021
Subject: Long-term budget projections and contingency planning

At your request, this memo discusses two topics: long-term budget projections and contingency plans. These fiscal management tools complement each other by helping states prepare for two different types of fiscal challenges. Multiyear projections are for identifying budget problems that build over the long-term, while contingency plans are for acute short-term crises.

Long-term budget projections

Long-term budget projections are forecasts of revenue and expenditures that look multiple years into the future (three to five years is most common). Developing these forecasts should involve more than simply extending trendlines beyond one or two budget cycles. Well-designed long-term budget projections should give policymakers an idea of the state’s structural position and a head start on improving that position by identifying the factors driving long-term challenges.

Structural balance signals whether revenues are expected to keep pace with expenditures. The value of knowing a state’s structural position is that it shows whether the state can afford new costs, or if it needs to scale back. Factors that can affect structural balance include policy changes, such as a new tax; demographic trends, like fewer schoolchildren leading to lower education expenses; and other cost drivers, like actuarially recommended pension contributions increasing. Once these types of factors are identified, they should be incorporated into forecasts and their relative magnitude should be explained.

Colorado’s Long-Range Financial Plan (LRFP) is notable for its analysis of key caseload trends and detailed discussion of risks facing the budget. Colorado could supplement these discussions by identifying policy options for potentially reducing the risks—an addition that may make the plan more actionable for policymakers.

To address each major threat to structural balance that the plan identifies, concurrent policies to reduce the threat should also be identified. When discussing the effects of an aging population, for instance, you could note that reducing tax deductions on pension income may lessen the negative fiscal impact. One model for this analysis is the Congressional Budget Office’s “Options for Reducing the Deficit” [report](#) which inventories dozens of options for increasing revenue or reducing spending, without endorsing specific policies.

Another way the plan could be used to inform policy decisions is to illustrate the effects of policy proposals under consideration. Rhode Island uses that strategy, allowing lawmakers to place proposed policies in the context the state’s overall budget position.

The Rhode Island Office of Management and Budget’s (OMB) most recent [five-year financial projections](#) forecast additional revenue anticipated as a result of the governor’s recommendation to legalize marijuana. They also analyzed policy proposals with expenditure impacts, such as the governor’s recommendation for enhancements to the state’s Child Care Assistance Program.

Another strength of Rhode Island’s analysis is that it combines revenue projections and spending projections to produce an overall assessment of budget balance. Ultimately, OMB’s forecast revealed that the state was expected to face a shortfall in all five fiscal years (although the analysis was completed prior to the passage of the American Rescue Plan Act).

Colorado’s analysis suggests the state’s long-term budget challenges by noting that spending growth absent policy changes is projected at 4.9%, but TABOR is likely to limit spending growth to 3%. Incorporating analysis of revenue trends could add further context to this finding, especially if revenue growth could come in below the TABOR limit.

Contingency plans

Most states, including Colorado, must maintain a balanced budget even when economic crises emerge unexpectedly, as was the case in spring of 2020. With limited time and options to find savings or generate additional revenue, officials often must make difficult decisions to close mid-year budget gaps. Well-designed contingency plans, however, can help relieve some of this pressure by establishing a process for addressing mid-year shortfalls before they occur.

Many states have some form of a contingency plan in law. C.R.S. § 24-75-201.5, serves as an example of this. Like in Colorado, these plans often give executive branches an opportunity to make budget corrections in response to a shortfall.

But not all contingency plans work well. Pew’s research found that in devising contingency plans, states should define what conditions will *trigger* contingencies, a *process* for eliminating shortfalls (including who has the authority to act), and the specific *actions* that may be used to balance the budget.

When contingency plans work poorly, it is often because one of these components—the trigger, the process, or the actions—is ill-defined or ill-conceived. For example, state statutes often grant governors broad discretion to adjust the budget to close gaps, but are silent on what actions are permissible—creating a recipe for governors to act unilaterally, without legislative input.

Likewise, triggers that are defined too narrowly risk preventing states from responding when budget conditions change. After the pandemic began, one of the largest sources of uncertainty for states was how much aid the federal government would provide and on what terms. With that in mind, some states included contingencies tied to federal aid in their budgets. California, for instance, [adopted \\$11 billion](#) in reductions and deferrals that would be reversed if the federal government provided aid by October 15, 2020. When Congress didn’t act in time, the state put the cuts in place—even though the [state’s budget situation](#) was already significantly brightening by then.

Just weeks later, [non-partisan legislative staff](#) found that the state had “overcorrected,” with cuts and budget balancing maneuvers that were far more drastic than necessary to bring the budget into balance. Had the state adopted a trigger based on the overall budget situation, not just federal aid, the state might have avoided the cuts.

One state with a well-established, long-standing budget contingency planning process is Arkansas. Under the state’s [Revenue Stabilization Law](#), appropriations are categorized according to priority-level, denoted by letters A, B, and C. Category A generally [maintains funding](#) for services at existing levels, B provides increases for funding priorities, and C contains increases for lower priority items.

These categories allow the state to adjust spending levels throughout the year. The state produces an Official General Revenue Forecast as needed. If revenues come in lower than expected, the chief financial officer does not provide funding for category C first, followed by category B. The last time category A received cuts was in 2010.

Arkansas’ approach holds several advantages compared to how states typically handle mid-year gaps. By setting priorities during regular sessions as part of the regular budget process, lawmakers have time to carefully weigh their decisions. Both the legislative and executive branches have central roles (though the executive branch retains significant power by producing the revenue forecasts that determine which categories are funded). The approach also helps state agencies and other recipients of state funding prepare—they know how much funding is in jeopardy and how much is virtually guaranteed.

In Colorado, C.R.S. § 24-75-201.5 already provides a “trigger” and “process” for addressing budget shortfalls. But Colorado may be able to strengthen its contingency plans by outlining, with greater specificity, the actions officials would be expected to take to close mid-year gaps. One way this could be done is by incorporating agency reversion planning, like the targets from OSPB’s FY 2020 Guidance for Fiscal Conservation, into the state’s regular budget process (beyond unspent funds). Such an exercise could, for example, ask agencies to develop plans for reversions at various percentage levels. That way, state officials and agencies are aware of policy priorities, where savings could be targeted, and potential impacts of budget balancing actions at different degrees.

Contingency plans should also account for potential variations in the depth and duration of mid-year shortfalls. The optimal way for states to do this is by performing [budget stress tests](#), or analyses that examine the impact of various economic scenarios on revenues and expenditures. (Our memo sent with this one on August 20, 2021 offers more details on stress testing.) States can then use the findings to develop a range of options for closing budget gaps. In Colorado, this could involve using stress tests to build on the concept of “budgeting to a range.” Lawmakers could adopt budgets that will scale up or down depending on revenue collections—allowing policymakers to plan ahead for both shortfalls and surpluses.