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Navigating the state financial crisis: Moving past business-as-usual planning and budgeting post-COVID-19

The COVID-19 pandemic has created and underscored countless financial-management challenges for state governments in the United States. To meet these fiscal demands, states can use the budget as a strategic-management tool.

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State budget and finance leaders face multiple challenges as a result of the unprecedented fiscal impact of the COVID-19 pandemic. The crisis is projected to result in more than $500 billion in budget deficits from 2020 to 2022 and affect state budgets more significantly than the Great Recession (Exhibit 1). Just as the 2008–09 recession led to budget shortfalls for five years after it hit, the fiscal impact of COVID-19 is likely to be prolonged.

States will be looking to federal intervention, rainy-day reserves, and near-term cuts to alleviate budget strain and revenue gaps, but these moves will likely prove insufficient. State governments must also transform[1] how they operate, including transforming the budget process in a way that ensures every dollar is spent productively and maximizes return on investment (ROI).

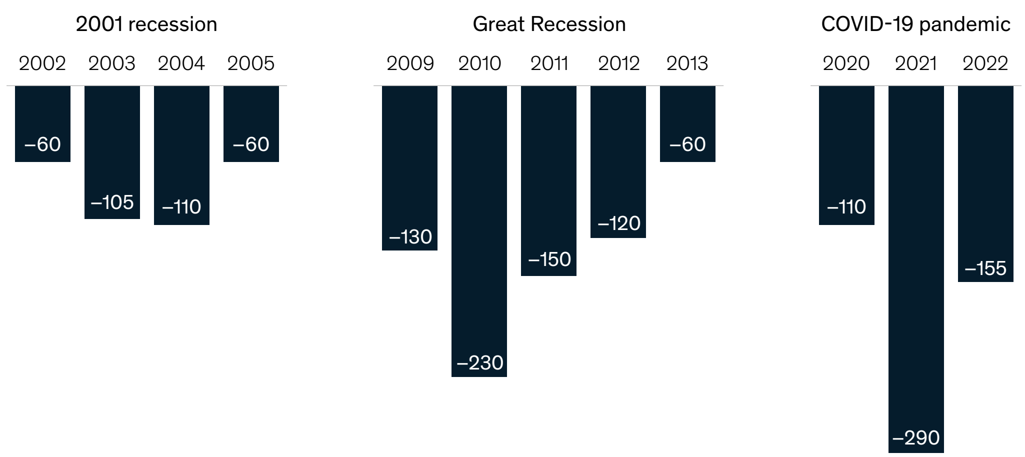
Many states are still taking a business-as-usual or "blunt object" approach to setting budget targets and reviewing spending. As one state budget officer told us, "We only look at new spend; we've never looked at the billions of dollars we budget year on year." Another stated, "We don't look at the core budget—we just know we will have to make difficult policy decisions."

Even state budget officers who utilize evidence-based approaches and performance-management systems have acknowledged that data from these systems are not used to inform most budget and investment decisions. Without the information to identify where the opportunities exist to promote efficiency and effectiveness, states may unnecessarily, or even unknowingly, make crippling cuts to important programs. While legislatures are often in charge of the final budget numbers, for

Exhibit 1

The COVID-19 pandemic will probably be worse for state budgets than the Great Recession—and is likely to last for years to come.

Total state-budget gap, billion 2020 dollars



Source: Center on Budget and Policy Priorities, July 2020

[1] For more on the state transformation mandate, see Trey Childress, Ian Jefferson, Aly Spencer, and Todd Wintner, "The state transformation mandate during COVID-19," June 15, 2020, McKinsey.com.

states to truly improve fiscal management, budget and finance leaders must ensure that the process takes a rigorous and strategic performance-management approach, rather than reducing budgeting to merely a superficial policy statement or high-level accounting exercise.

Conversations with several state budget and finance leaders underscore the importance of adopting a more strategic process to support transformation and navigate the uncertainty of the COVID-19 crisis. Given the magnitude of the current situation, however, this approach is only part of the answer. Without adopting a more efficient and rigorous budgeting process, states will struggle to address the current fiscal crisis, or any that occur in the future. In this article, we propose four measures to transform state-budgeting practices—making the process more dynamic, tactical, and mission-driven.

Stress-test the budget through dynamic scenario planning

Budget teams typically rely on annual straight-line projections to set agencies' budget targets, using historical revenue or population-growth rates and sometimes incorporating forward-looking macroeconomic data. Many states do not regularly engage their agencies in scenario planning to help set expectations or inform budgeting decisions. Forward-looking states, meanwhile, have adopted practices that lend more confidence to budget projections and enable a more proactive approach to managing potential revenue shortfalls.

Some states are looking past standard indicators such as overall US GDP trends or past revenue receipts to see where revenues may land. A budget director of a Southern state noted, "One practice we will bring from the COVID-19 pandemic is a willingness to rely on new indicators beyond the typical economic data points. We're looking at OpenTable reservations, TSA traffic, Apple mobility data, film box-office data, and hotel occupancy—all in an attempt to understand how people are behaving and what economic activity might be returning." Additionally, taking a driver-based approach for specific revenue sources will bring further nuance to projections. For example, budget officials might ask, "How will sales tax be impacted?" while reviewing the overarching impact on the major business sectors and consumer spending that contribute to this stream, rather than simply inquiring, "How will general fund revenues be impacted?"

Similarly, leading states are developing multiple scenarios for revenues and expenditures and using them to stress-test the budget. By forecasting revenue scenarios—based on potential economic environments (and in the case of the COVID-19 pandemic, its progression)—states can ensure that their planning takes into account the diversity of possible outcomes given ongoing uncertainty. States can then use conservative projections to stress-test where there may be shortfalls or gaps in the budget and engage their agencies in a proactive response.

One Midwestern state, for example, has been using projections of both expenditures and revenues to pressure-test its budgets. At one point, its projections showed rosy revenues for the next fiscal cycle but a downturn several years out, rendering planned education increases unsustainable. The state, therefore, matched these expenditures with tax and fee increases to ensure there would be enough money to cover them in the long term—and to avoid harsh cuts that many states are now facing.

A Mountain state projects expenditures and revenues several years out and identifies potential shortfalls and funds, such as reserves, readily available to address the gaps. The state then uses projected budget deficits to define the operational and policy actions it will take to meet such deficits if they arrive. With robust real-time tracking of actual spending and receipts, states can also monitor which scenario is coming to pass and intervene with more precision, mitigating disruption, wherever possible, to important programs.

Build the budget with a strategy-back, ground-up approach

State budgets are typically structured around a "last year plus" approach. Agencies propose the tweaks they need to make to previous years' budgets, rather than defending them from the ground up and tying budget requests to clear, detailed strategic objectives. This obscures visibility into how the budget will underpin mission priorities and makes it much harder to assess and change strategic intent.

Rather than focusing on incremental changes, agency budget submissions should address long-term strategic goals and the discrete objectives for the upcoming year. The strategy should then be used to determine the operating needs of the activities and programs that contribute to it, and the budget build (for example, a list of operational and personnel expenditures) needed to support them. Agencies should be prepared to discuss how their aspirations translate into their total budget needs, rather than just explain how this year compares with the last.

One Western state does this well. The state requires that all budget submissions be tied to the strategic goals and priority activities and programs that an agency would like to pursue, as well as to the operating environment and organizational factors facing the agency. The agency must also explain how it will measure progress, what milestones it will track, and what resources may be needed to accomplish its goals.

This approach to the budget implies that discussions occur strategic objective by strategic objective, with agencies required to translate how each dollar will affect results—for example, customers served, claims processed, and audits completed. Strategy should be provided through clear objectives and outcomes at each level of an agency's structure and not limited to just the high-level outcomes that the state may aspire to. As one former state budget officer noted, "It was only once we were able to justify and tie dollars spent to the number of claims processed or individuals served that we were able to truly change how agencies drove toward performance, and to measure it accordingly."

Moving to a strategy-back and ground-up view of the budget might shift mindsets among agency leads, who could start to see why reallocating resources once considered permanently part of the base can be beneficial to program outcomes and enable investment in higher priorities.

Use the decision-making process to surface opportunity

Budget-setting discussions are often transactional encounters where budget directors review agency submissions line item by line item and ask clarifying questions before deciding allocations. This dynamic leaves little room for rigorous debate. Such discussion, however, is crucial to effective decision making, especially when considering major changes to budgets or programs or to surface opportunities to spur efficiency and effectiveness in service delivery and spending.

State budget directors might consider the new approaches that some private-sector companies have pursued in response to the pandemic—techniques aimed at enforcing objective, debiased, and dynamic decision making in budgeting and planning discussions. One method involves hosting challenge sessions, in which business units defend their budget needs to a set of peers and budget officers. This can be a helpful approach for budget teams that typically rely on agencies for ideas on where to find opportunities for spending reductions. Using outside-in benchmarks (for example, average spending per student in peer states or average unemployment-insurance claims processed daily), best practices (for example, process redesign to enhance customer experience or creation of a centralized procurement portal to enable agencies to save money and access high-quality vendors) and new tools or data (for example, using procurement analytics or customer-experience or -journey analytics to identify new opportunities) can help set an aspiration that agencies did not know was possible.

Other companies use a red team–blue team approach, in which two groups take opposite sides for a particular decision. One electric utility used this technique when trying to determine what to do with its core strategic business unit, which was suffering from a broken business model. It staffed two different teams to come up with two different proposals for a pathway forward, with the aim of encouraging radical, creative thinking. One team offered an incremental solution, while the other felt empowered to propose something more dramatic—breaking the company in two. The utility pursued this proposal, which led to the successful initial public offering of a new company. Such an approach can be particularly helpful for budget directors reflecting on which initiatives they would like to undertake to save money or to improve the delivery of government services, as it often surfaces new information that would not otherwise be considered.

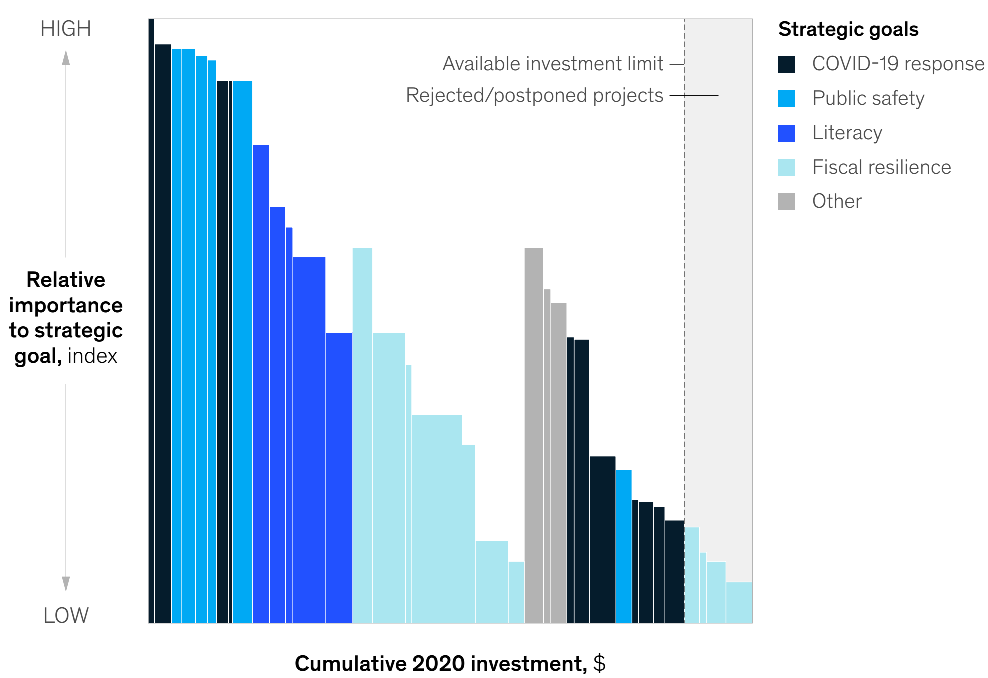
Finally, some companies have adopted ROI-based or rank-ordering approaches to current and new spending and priorities, developing a portfolio of projects by weighing them by impact and investment. For governmental entities, impact is not about financial performance but rather about contribution to mission outcomes. A semigovernmental power utility used this type of approach when developing a portfolio of projects—ranking them by not only financial performance but also carbon emissions and risk aspects. The utility arrived at a portfolio that maximized the contribution to its mission objectives while staying within its spending limits.

To replicate this activity, budget offices should define the investment cells (for example, strategic priorities) that various projects are contributing to, identify the contribution each makes to that particular goal (and estimate the level of investment or current spending associated with that project), rank projects or programs within departments or strategic objectives, and then rank them across objectives (Exhibit 2). Just undergoing this ROI-assessment process can facilitate a portfolio mindset in which leaders can have productive discussions about allocating resources to advance particular goals.

Exhibit 2

Ranking expenditures by importance, regardless of department, forces tough conversations.

Illustrative ranking of projects



States looking for ways to prioritize outcomes even as budgets contract will need to fully integrate performance management and financial management.

Tie performance management to the budget

For many states, performance management conjures up bureaucratic reporting requirements and failed efforts at performance-based budgeting. For states that do prioritize performance management, it often fails to drive resource allocation. As one budget officer acknowledged, "We never apply our performance-management findings to budget decisions." States looking for ways to prioritize outcomes even as budgets contract will need to fully integrate performance management and financial management—ensuring dollars spent can be accounted for and goals achieved as efficiently as possible.

Budget officers should bring financial data into every performance-management discussion. Indeed, one key success factor that budget and finance officers have noted is the ability to parse what trendlines may be problematic versus normal or seasonal variation, and what impact various policy or rule changes could have on revenues and expenditures. Two Mid-Atlantic states, for instance, set aside nonrecurring revenues (general fund revenues and personal income tax, respectively) that exceed long-term trendlines—in other words, they do not assume these revenues will be accessible or realized when setting longer-term budget targets.

Distinguishing normal variation from worrying trends relies on having access to significant historical data (for example, monthly revenues by type for the past five years) as well as knowledge of how past actions (for example, revenue and expenditure policy changes after the Great Recession) affected historical results. Budget teams can combine this data with performance-management milestones to have productive discussions about how past actions are influencing trends. Finance leaders in one government entity pursuing a transformation used this approach well. On a monthly basis, budget to actuals for payroll and nonpayroll were reviewed along with transformation objectives to identify operational pressure points and prioritize interventions to address long-term structural challenges, such as inefficient staffing models. In the past, the leaders might have fallen back on Band-Aid solutions (for example, incentives for early retirement) that yield lucrative short-term returns but fail to remove systematic binding constraints. In this case, the government's agencies came away with action plans to correct course.

Bringing together operational and financial data is especially important for dynamic resource reallocation. To ensure money is used properly when the budget is tight, budget-office leaders either use stage-gated funds or require operating plans for reapportionment (fund transfer) requests. One Southern state, for example, uses stage-gated funds when an agency requests new projects or forecasts cost increases, requiring the agency to reach agreed-upon milestones of performance to ensure the funds can be released. Another Southern state requires agencies to submit operating plans for reapportionment requests to ensure that the agency requesting funding has clear goals as well as a plan to use the money correctly.

To make performance management more dynamic in the wake of the COVID-19 pandemic, many states have also adopted a faster pace. One CFO of an East Coast state brought everyone—the comptroller, budget team, and core operators—into the same room on a daily basis to act as a control tower for spending reviews and to protect liquidity through the crisis. Budget-to-actuals tracking and performance monitoring may have once been a quarterly arm's-length accounting exercise, but in the face of extreme budget uncertainty, there is an imperative to understand agencies' progress in real time. In partnership with agency leaders, state budget offices can identify trends, understand where the greatest needs exist, assess how complex interventions are playing out, and develop actions to address the evolving situation.

As states grapple with the possibility of years of deficits and the need to transform their operations, the time is ripe to use the budget as a strategic-management tool. Budget and finance officers can begin shoring up the information and decision-making processes they will require to make insight-driven decisions that promote operational efficiency and effectiveness. There is no good time to make hard changes—some of which may feel especially tough in a crisis. States that take a transformation mindset, however, will see the changes forced upon them as an opportunity to enter a new era of fiscal management. Robust financial-management practices—built on careful consideration of what is working, what has broken down, and what would have been helpful from the start of the pandemic—could allow states to get through this crisis and ahead of the next one.

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