WINTON POLICY GROUP

# Governor and Legislature Grapple with Budget Uncertainty Due to Pandemic

*Cash Flow Issues Make Budget Withholds Likely*

Missourians have been dealing with the COVID-19 pandemic in earnest for over three weeks. During this time, Missourians have limited their activity through government ordinances and prudent behaviors. There has been much discussion on the national economic turmoil precipitated by the crisis, and economic experts continue to warn of a prolonged slump. The first analyses likened the pandemic's impact on the US economy to September 11, 2001 rather than the Great Recession of 2008. In short, the idea was that the economy has a strong foundation, and when the crisis passes, the economy should recover quickly. As the reality of COVID-19 has set in, many of these models are looking more closely at the possibility of a real recession. The federal government is attempting to blunt the impact of the economic harm brought on by the slow down, and in some cases full stop, of the nation's commercial and economic activity. The US Congress passed three major relief bills that will make over $3 trillion available over the next year, and the Federal Reserve continues to pump liquidity into the economy. However, there are certain short- and long-term considerations that Governors and lawmakers will be facing across the US.

In Missouri we can think of the immediate issue facing state government as a massive cash flow problem, while the longer-term prognosis is far less certain.  We wanted to provide some context and suggestions about what may happen next. It may be helpful to note a few key items:

- Individual income tax comprises approximately 70% of Missouri's general revenue (GR) budget, and sales/ use tax accounts for a little over 20%;
- Much of Missouri's federal funding is tied to state expenditures through a variety of matching programs, most notably Medicaid. Therefore, any change in state GR is likely to have an impact on federal funding.
- Missouri, like most states, has a limited capacity to borrow funds. Even if it was permitted, the political environment would make this option virtually impossible.
- The three federal COVID bills will inject a substantial amount of revenue into the Missouri economy and local governments, some of which will offset the state's GR losses as well as reimburse the state and local governments for enhanced activities.
- With any recession, the programmatic costs associated with safety net services also rise and require additional state and federal spending.

**Getting Through June 30, 2020 (The Short Term)** - One of the first actions taken by the federal government was to move the tax filing deadline to July 15 from April 15. This may not seem like a cause for alarm; however, the repercussions of this action are serious for states across the US that followed the federal lead. In Missouri, this is an automatic action since Missouri's state income tax guidelines mirror the federal guidelines. The net effect of this action is significant cash flow issues between April 15 and July 15. In almost every year, Missouri families that overpay their taxes file and request refunds throughout the first quarter with the height of this activity in March and April. Those that owe taxes generally wait until the filing deadline of April 15 to pay the remaining bill. This always causes a short-term cash flow issue. The state borrows from itself through a special fund that helps manage operational cash so Missouri can continue to pay its regular bills.

However, due to the tax filing extension, this gap increased from 4-6 weeks to 12-14 weeks. It is still expected that Missourians will make refund requests in March and April, and the bulk of 2019 tax payments will be made near the July 15 deadline. It is unlikely the state's fund balance and reserves are sufficient to meet the state's obligations in this environment. Therefore, we expect the Governor to announce withholdings from the current state budget cycle (SFY 2020, which ends June 30, 2020) to address this issue. The size of this withholding will be influenced by the shortfall expected in this window as well as whether or not the Administration believes the Missouri budget will have to be reduced going forward. The safe answer to that set of questions is yes, which is likely to force the Governor to declare withholdings beyond what is needed to close the cash flow gap. However, the degree of this is far less certain. It is important to note that withholds can be reversed anytime during the fiscal year. Therefore, if the projections prove to be overly aggressive, the Administration can release some or all of this funding, which happens routinely.

There are two other actions that must be taken by the Legislature in the very short term. The first is the passage of the SFY 2020 supplemental appropriations bill. This is a routine action which allows the state to "true up" the budget. As with all budgets, the state budget is predicated on a complex set of assumptions from revenue projections to program utilization. This is sorted out when the accuracy of those assumptions is confirmed in February/March, since more than three-quarters of the fiscal year has elapsed. The supplemental budget is passed to allocate additional funds needed to finish out the fiscal year.

The urgency of a supplemental bill in 2020 is the need to allow federal assistance funds to flow to Missouri and provide a pathway for those funds to be expended. Without this action, Missouri cannot accept the federal funds into its treasury or expend non-appropriated revenues. The second necessary legislative action is the reauthorization of the Federal Reimbursement Allowance (FRA) statute, which is a broad tax on medical providers including hospitals, nursing homes, pharmacists, and EMS. These provider taxes generate over $1 billion of GR "look alike" funds, which are critical to drawing down the federal share of the state's Medicaid program.

The Legislature is scheduled to reconvene April 7 and April 8 to pass the FRA and the supplemental budget. This will give the state authority to accept new federal funds and spend that money through the remainder of SFY 2020. The House passed both of these bills the week of March 16, and they are now in the Senate.

**Looking Forward to SFY 2021 (July 1, 2020 - June 30, 2021)** - Currently the Legislature is debating the SFY 2021 budget, which will fund state government from July 1, 2020 to June 30, 2021. The pre-COVID budget was built on a modest growth projection, under 2%. The budget bills are awaiting House debate and passage. Once the House completes their work, the Senate will work though a similar committee process to make adjustments based on their priorities as well as more refined revenue projections. This process normally takes around five weeks with an additional week for conference committees to iron out differences between the two chambers. However, the certainty of this process is in jeopardy. Timing and pressure from the Administration will significantly alter the normal legislative budget process:

- *Timing:* Legislative leadership is grappling with a shortened session and making determinations regarding the safety of convening in the state Capitol. Even in the best-case scenario, the Legislature will have a handful of days for floor debate between now and the Constitutional close of session on May 15. In addition to abandoning all but a handful of priorities, they are discussing a way to reach consensus on the SFY 2021 budget to avoid drawn out conference committees and extended floor debate since the budget is due to the Governor on May 8. This is likely to involve substantial negotiation with budget leaders from both sides of the aisle as well as Legislative leadership. It is possible this becomes a unity budget at its core, but that would take a tremendous amount of discipline from elected officials that have become increasingly partisan over the past decade.
- *Pressure:* The Administration will push the Legislature to severely cut or actually restart the budget process to account for the COVID-19 reality. This is more a political discussion as the Governor has the ability to quickly react to fiscal realities through both line item vetoes prior to July 1 and broad withholding power throughout the fiscal year. However, no Governor wants to make such difficult decisions. If the Legislature substantially reduces expenditures, the Governor is more likely to be in a restoration mode. With an election in November, this could be a key issue for Parson. This dynamic is not unique to our current Governor, and to a certain extent this is the normal tug of war between the Executive and Legislative branches. However, the heightened uncertainty brings this tension into sharper focus.

**Looking for Clues -** If past is prologue, then we can expect a mix of politics and policy in all this decision making. It seems likely that:

- Governor Parson will announce immediate withholdings to brace for the inevitable and impending cash flow issue. The size of the withholds is unclear, and he may choose to do this in a series. Governor Parson may announce a first wave this week between $50 and $100 million and signal there could be more to come based on needs.
- The Legislature will pass the supplemental appropriations bill next week as well as the FRA extension. The supplemental budget bill is likely to be very open ended, giving the Administration considerable flexibility in accepting and spending revenues.
- The Legislature is likely to pass a SFY 2021 budget during the current session through a shortened process to avoid conference committee, or at least a prolonged

conference committee process. It is likely this bill will have reduced spending.

- The Legislature is likely to file and pass a COVID spending bill that allows for the acceptance of COVID-related funding throughout the operating budget as well as broad expenditure authority. A separate bill reduces the process while allowing a tracking mechanism for federal funding.
- Federal funding will fill many of the shortfalls, and in some instances create a windfall for certain accounts.
- Unemployment will spike in the short-term, and the state will focus on economic development activities to get people back to work as quickly as possible. We are already seeing this, and the President of the Federal Reserve Bank of St. Louis predicts up to 30% unemployment.
- There will be a fourth federal COVID-19 bill, which will continue to inject money into states.

We will provide more information as it becomes available, but we hope this is helpful in understanding the immediate set of data in front of the state.