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REPORT

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MAKING MISSOURI RESILIENT: ASSESSING STATE AND LOCAL GOVERNMENT RECESSION PREPAREDNESS

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KEY TAKEAWAYS

- Missouri's budget was not ready for the COVID-19 pandemic or the economic downturn that followed. In fact, according to Moody's Analytics, Missouri was one of the least-prepared states in the country.

- Public policy decisions can affect not only how damaging a recession is to a state or local economy, but also how hard it is to recover. Missouri and its largest cities rely heavily on income and sales taxes, which are relatively volatile streams of revenue. During an economic downturn, increased revenue volatility in the presence of a balanced budget requirement can make it more difficult for governments to provide their usual level of services.

ADVANCING LIBERTY WITH RESPONSIBILITY BY PROMOTING MARKET SOLUTIONS FOR MISSOURI PUBLIC POLICY

- When economic activity declines, government tax revenues typically fall, and certain expenditures rise. In response, states can turn to rainy-day funds to help make ends meet. But due to various rules surrounding the use of Missouri's rainy-day fund, it has never been used for this purpose.
- By reducing reliance on volatile forms of taxation, reining in tax incentive programs, and reforming the state's rainy-day fund, Missouri and its largest cities can be better prepared for the next economic downturn.

INTRODUCTION

With the arrival of COVID-19 in the first few months of 2020, American life and the relationship between citizens and government changed drastically. On March 13, the President of the United States and Missouri's governor declared a state of emergency for the pandemic.[1] In the months that followed, schools closed, businesses shut down, and Missourians drastically cut their daily mobility due to stay-at-home orders and uncertainty about the virus. As a result of the pandemic, millions of workers became unemployed and economic activity contracted as the United States entered its first recession in over a decade. While the long-run effects of the pandemic may not be known for some time, the events of the past year offer an opportunity to assess how Missouri's public policies impact preparedness for the disruption caused by this and other unforeseen economic shocks.

An economic shock is an unexpected disturbance caused by nature or events external to the decision making of households and businesses that has a substantial effect on the whole economy. Depending on the nature and magnitude of these shocks, they can have large-scale effects on economic indicators like the unemployment rate or the growth rate of gross domestic product (GDP). Natural disasters and unpredictable technological changes are common examples of economic shocks. The COVID-19 pandemic is also an example of a negative economic shock. Without warning, many industries shut down and millions became unemployed. The pandemic dramatically changed the trajectory of the global economy. According to the National Bureau of Economic Research, the United States entered a recession in February of 2020.

This report will elaborate on Missouri's state and local policies and structures that inhibit the resilience of state and local governments to handle economic shocks and hinder the recovery efforts that follow. It will also outline some possible policy changes that would put Missouri and Missouri's largest cities in a better position to handle future economic disruptions.

RECESSIONS IN MISSOURI

As soon as confirmed COVID-19 cases in Missouri started rising, government-imposed lockdown measures and private precautionary behaviors precipitated an immediate and sharp economic decline. Missouri's GDP fell by 32.1 percent from the first quarter (January through March) to the second (April through June) in 2020 (Figure 1).[2] Missouri's unemployment rate had been very low prior to COVID-19—hovering below 3.5 percent for all of 2019—but jumped to 12.5 percent in April 2020 (Figure 2).[3] After reaching such a high peak, the unemployment rate has since fallen quickly relative to the speed of previous recoveries, though as of April 2021 it has yet to return to pre-pandemic levels.

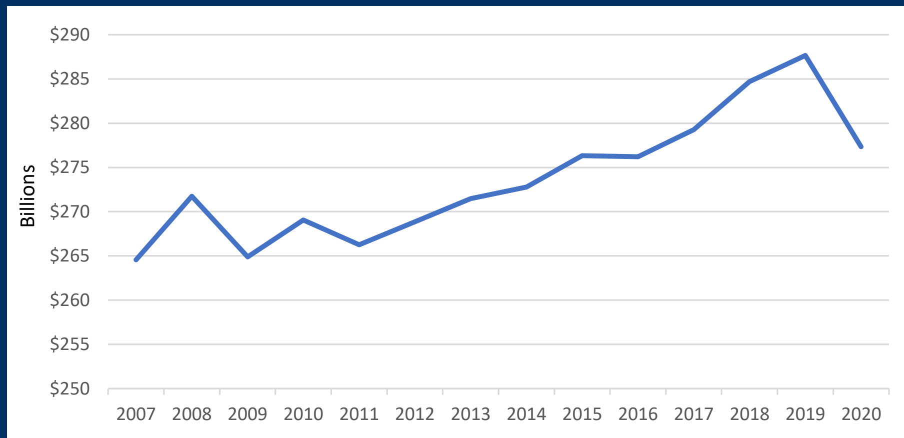
The unprecedented nature of the COVID-19 pandemic and the government's response complicate comparisons with past downturns, but there is still value in evaluating past trends and recovery performance. Missouri's most recent recession in 2008 was characterized by a less abrupt though still large deterioration in GDP and unemployment, as seen in Figures 1 and 2. The state then took several years for each metric to recover to pre-recession levels. Of course, the cause of the 2008 recession was much different than the one in 2020, but in both cases the downturns adversely impacted state and local government revenues.

Generally, economic downturns put pressure on state and local budgets because governments simultaneously experience a decrease in revenues and an increase in expenditures. As economic activity falls, the unemployment rate typically rises, causing a reduction in income tax receipts, though this drop is mitigated by the fact that Missouri collects taxes on unemployment insurance benefits. People also tend to pull back on consumer spending during downturns, which impairs sales tax receipts. At the same time, spending on unemployment insurance and other automatic stabilizer programs (food stamps, Medicaid, etc.) rises during recessions, adding further strain to the state budget. Nationally, the single biggest expense for state governments is the provision of health care coverage through the Medicaid program, which can amount to hundreds of millions of dollars in new state spending during a recession.[4]

Crises can also persistently change consumer behavior. From 2008 to 2011, the national housing market experienced its largest collapse since the Great Depression, decreasing people's willingness and ability to purchase or sell their homes.[5] To this day, the homeownership rate is still several percentage points below its 2005 peak. In 2020, the pandemic reduced in-store shopping and induced a massive shift to online commerce that is unlikely to fully revert. Problematically for the state budget, Missouri remains one of the few states in the country that does not collect sales taxes for online purchases made from out-of-state sellers.

Figure 1:
Missouri Gross Domestic Product

Missouri's GDP was immediately affected by the economic shutdown.



Source: Bureau of Economic Analysis.
GDP values are in billions of chained 2012 dollars.

Figure 2:
Missouri Unemployment Rate

Missouri's unemployment rate rose dramatically due to the economic shutdown and has not dropped to pre-shutdown levels.

Source: U.S. Bureau of Labor Statistics.

The combined decrease in tax revenues and increase in costs can pose serious problems for state and local governments during an economic downturn. Missouri requires both its state and local governments to maintain balanced budgets, which means that they cannot spend more money than they take in over a given year. As seen in Figure 3, when an economic shock occurs, tax revenues can deviate by more than 10 percent from their budgeted estimates. Such sudden shortfalls, in turn, force elected officials to make hasty decisions regarding which services to cut to rebalance the budget. If misaligned with long-term spending priorities, these swift cuts can harm growth in the recovery by reducing critical investments in areas that affect the state's competitive position.

GRADING MISSOURI'S PREPARATION

While some deterioration in state finances is unavoidable during an economic downturn, public policies can affect the resilience of the budget in weathering these swings and therefore the strength of the recovery that follows. Missouri's slow recovery period after the 2008 recession serves as a reminder of the stakes involved in being prepared for an economic downturn. To quantify and rank the preparedness of different state budgets to future economic shocks, Moody's Analytics (the financial analysis arm of the credit rating agency) began regularly conducting stress tests shortly after the Great Recession ended.

To conduct their analysis, Moody's inputs different economic scenarios into quantitative models to estimate how state revenues and spending needs could be impacted. Those results are weighed against the state's ability to absorb that stress, which produces an overall ranking.

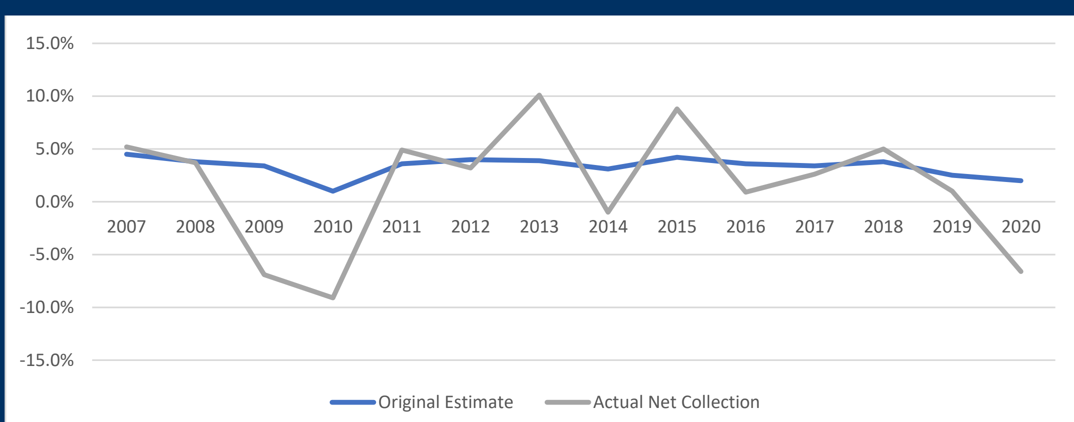
Unfortunately for Missouri, the state performed poorly in Moody's April 2020 report in all three of its included metrics (discussed below) and emerged with a ranking of 4th worst prepared in the country.[6]

For the first metric, Moody's estimated the severity of tax revenue declines under different economic scenarios. Using each state's composition of taxes and industrial mix, the recent report projected Missouri to experience the 8th-worst revenue decline in the country in the event of a COVID-19 induced recession. The conclusion was based in part on how Moody's predicted that Missouri's businesses would be impacted by a pandemic, but also on the state's heavy reliance on sales and income taxes, which can be volatile sources of revenue during a downturn.

Next, Moody's estimated the likely response of automatic stabilizer spending in the state to a recession. The idea behind this simulation is that, when economic activity declines and the unemployment rate goes up, the newly unemployed can become eligible for various safety net programs such as Medicaid, which increases government spending on these programs. For states, the Medicaid program is already one of their biggest yearly expenditures because of the nature of the funding relationship with the federal government. Based on Missouri's estimated increase in unemployment during a recession, current Medicaid eligibility guidelines, and how much the state already spends on the program, Moody's projects Missouri would experience the 4th-highest increase in Medicaid

Figure 3:
General Revenue Estimates and Actual Net Collections

When an economic shock occurs, state tax revenues can differ from budgeted estimates by more than 10 percent.



Source: Missouri House of Representative Budget Fast Facts expenditures in the country. Finally, Moody's report combines the spending and revenues results to produce an estimate for the total fiscal shock each state could experience. The estimated shortfall is then compared to the balance of the state's available rainy-day fund—a budget reserve that, in principle, lawmakers can tap during downturns—to determine how much could be absorbed. This is yet another area where Missouri does not fare well in Moody's analysis. Missouri's rainy-day fund is among the smallest in the country and is prohibitively difficult to use when needed. A comprehensive accounting of the fund's deficiencies appears later in this report.

Missouri's balanced budget requirements make a well-functioning rainy-day fund all the more necessary to cushion the blow from fiscal shocks. Otherwise, if a shock occurs and there aren't funds available to fill whatever hole is created in the budget—such as aid from the federal government, which has its own drawbacks—the service cuts or tax hikes necessary to maintain balance will have to be more extreme.

The rest of this report will outline the various public policies that impact Missouri's preparedness and chart a course for improving the state's resilience in the face of economic shocks.

REVENUE VOLATILITY

Revenue volatility can pose a huge problem for governments during an economic downturn. If a government's revenue stream is volatile, that means that it is subject to dramatic swings. For example, a revenue stream that is $10 million in year 1, $15 million in year 2, and $5 million in year 3 is more volatile than a revenue stream that is $10 million in year 1, $11 million in year 2, and $9 million in year 3.

Depending on the broadness of each tax base, income taxes are typically the most volatile revenue source, followed by sales taxes, and then property taxes.[7] During economic downturns (and especially during an economic shutdown), income taxes fall as people lose their jobs. In response to a loss of employment, people tend to reduce spending, though less than dollar-for-dollar with lost earnings because of savings and credit. Even so, sales taxes can still tumble during a recession. By contrast, property tax revenues depend on property value assessments, which occur at a lag. In addition, decisions related to property tend to be less elastic and are more resistant to change than decisions that affect sales tax collections. Moreover, in the case of many recessions outside the unique 2007–09 housing crisis, house prices may not fall much at all in dollar terms, leading to very stable property tax revenues. This relative stability has proven especially true during the 2020 pandemic recession.[8]

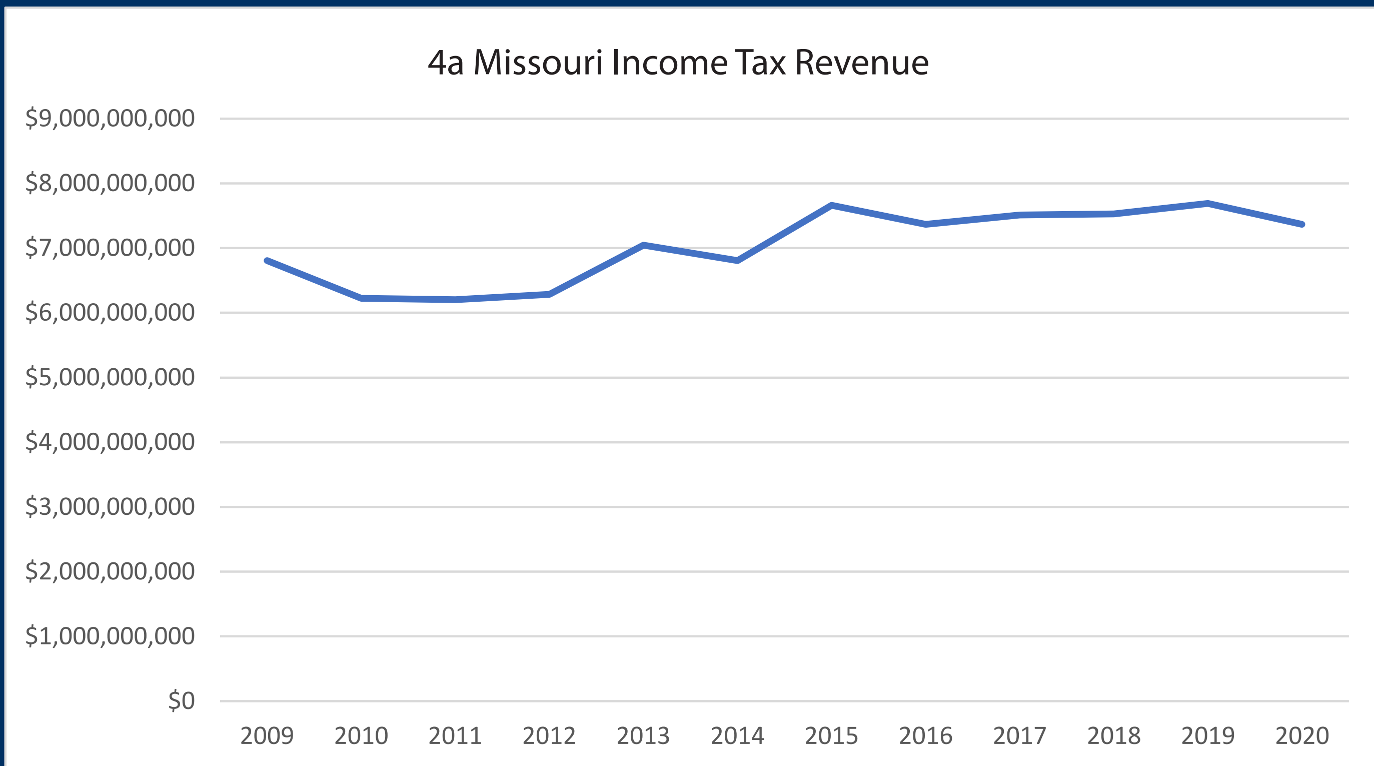
The data bear this discussion out. The graphs in Figure 4 show revenue collections for Missouri, Kansas City, and St. Louis city from 2008 to 2019. State revenue collections don't have property tax collections as a reference, but there are large fluctuations in income and sales tax revenue collections. In this period, income tax collections and sales tax collections had a one-year change as high as $851 million and $291 million, respectively.[9] That's a substantial difference in revenues from one year to the next. The Kansas City and St. Louis City figures paint a similar picture; revenue collections from income and sales taxes can vary drastically from year to year while revenues from property taxes have less variation.

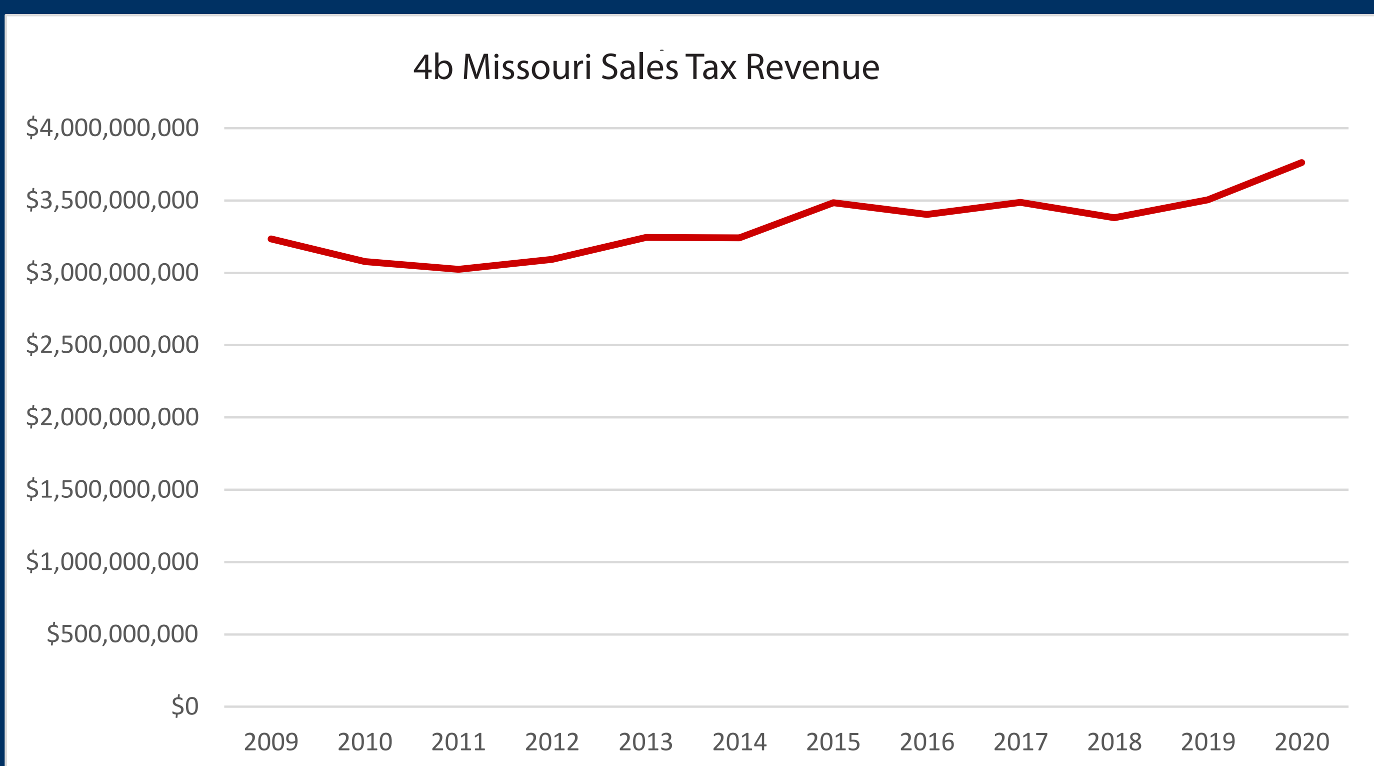
Reliance on Volatile Forms of Taxation

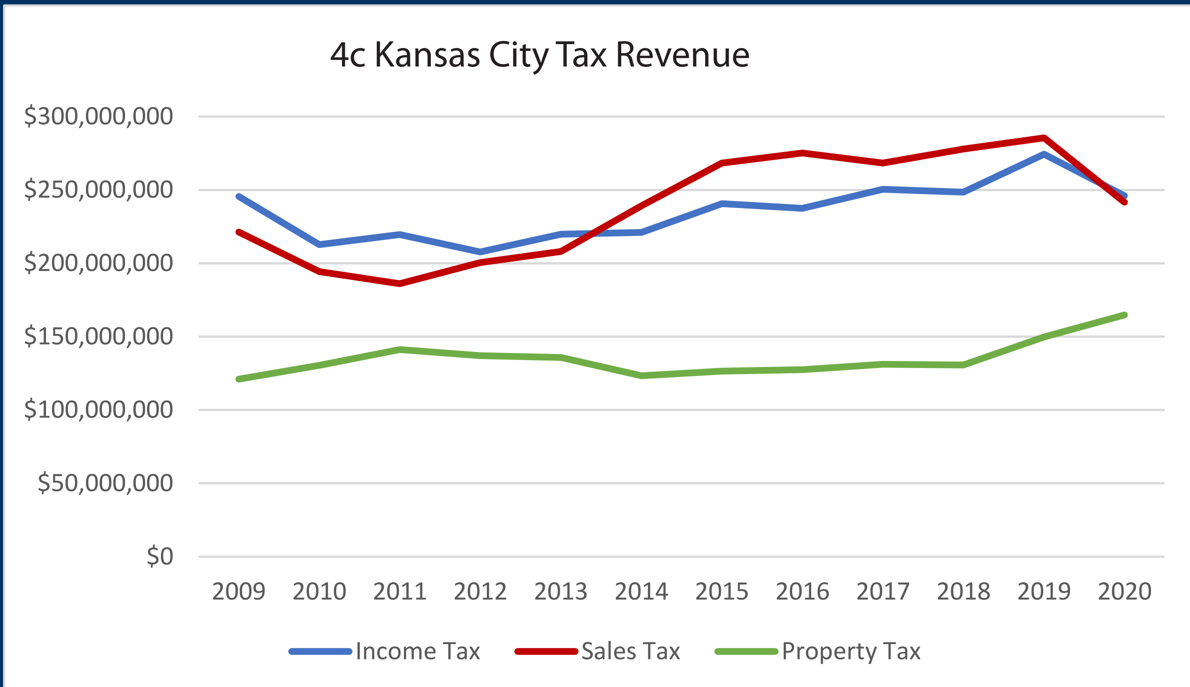
Missouri state government relies more heavily on income taxes than sales taxes, with data from the Census Bureau showing that income taxes account for 49 percent of state tax revenues compared to the national average share of 37 percent.[10] Missouri's state government is the 8th most reliant on income taxes, but the 33rd most reliant on sales taxes. At the local level, Missouri cities rely on sales taxes much more than property taxes.[11] St. Louis City and Kansas City, the state's largest cities and the only cities with local income taxes, rely heavily on both income and sales taxes. Overall, Missouri local governments rank 8th for income tax reliance and 10th on sales taxes.[12] This composition of taxes is unfortunate considering that income taxes are more volatile than sales taxes—exposing the state to greater risk—and sales taxes in turn are more volatile than property taxes—making localities more vulnerable. One author even found that increased reliance on the income tax base explains most of the state-level tax revenue volatility that we've seen in the 2000s.[13]

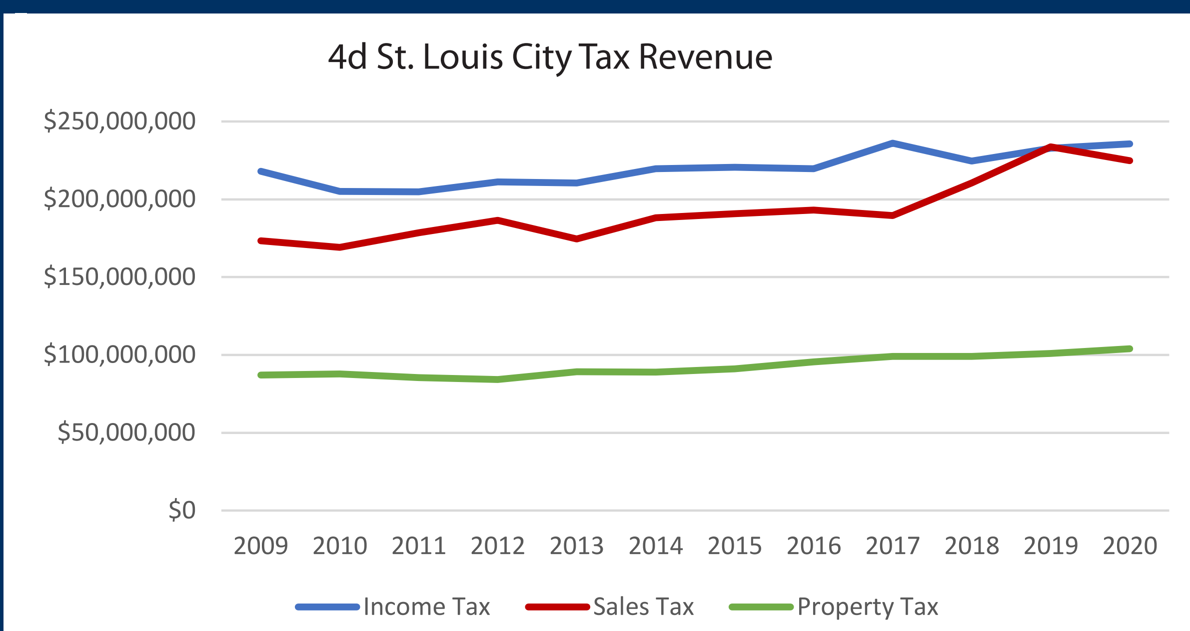
Figures 4a, 4b, 4c, and 4d:

Income and sales tax revenues tend to be more volatile than other types of tax revenue, specifically property tax revenue.









Note: Tax revenue numbers have been adjusted for inflation to 2020 dollars.

Source: State and local comprehensive annual financial reports.

Figure 5 shows a breakdown of total revenues for Missouri and its five largest cities in 2019. Income and sales taxes (dark blue and orange) make up a large portion of total revenue, reaching almost 40 percent for Missouri, Kansas City, the City of St. Louis, and Springfield.

A similar graph (Figure 6) showing general revenues from fiscal year 2019 emphasizes this point. General revenues are the component of total revenues that aren't dedicated by statute to a specific purpose and can therefore be spent more flexibly. Income and sales tax make up at least 50 percent of general revenues for every locality and make up over 80 percent of the state's general revenues.

These are not new trends, either. Income and sales taxes have made up over 73 percent of Missouri's general revenues over the last ten years.[14] Similarly, these types of taxes have made up over 63 percent of general revenues for St. Louis and between 58 percent and 71 percent of general revenues for Kansas City over the last decade.[15] For the cities that do not have their own income taxes, sales taxes have made up a significant portion of general revenue for years. Sales taxes have made up an average of 66 percent of general revenues for Springfield, 57 percent for Columbia, and 61 percent for Independence over the last ten years.[16]

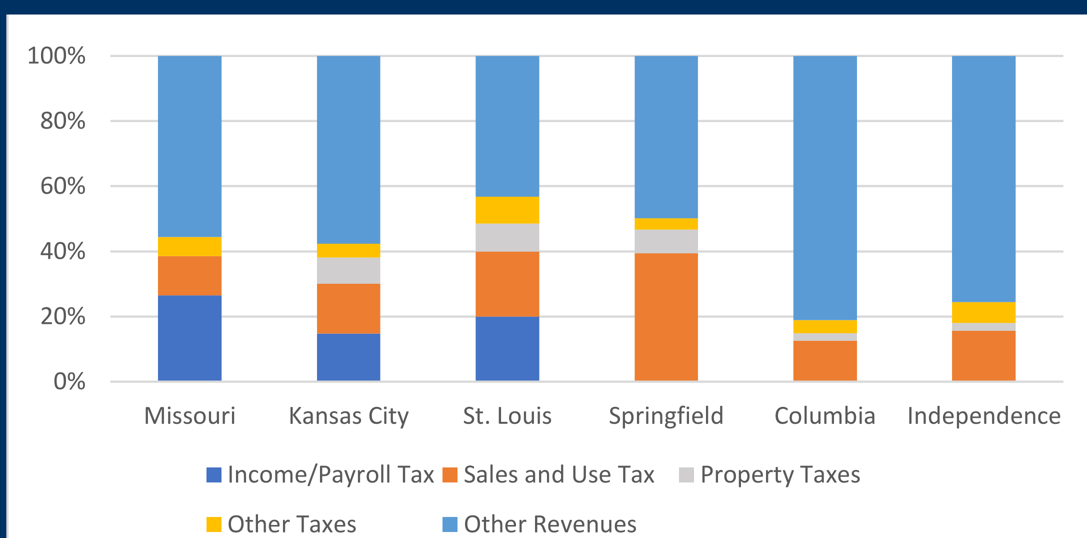
The reliance of Missouri and its largest cities on these volatile types of taxes may have serious consequences for government revenues as the state recovers from the 2020 economic shock. During the crisis Missouri experienced high unemployment, and many businesses were temporarily closed. It was predicted that the shutdown would lead to huge decreases in revenues from income and sales taxes. This may not have happened in the short term due to federal relief packages, which will be briefly discussed later in the paper, but it's still difficult to predict what will happen with revenue levels as the economy recovers. The uncertain revenue outlook poses a problem for Missouri and for cities that rely heavily on these taxes to fund programs and services.

Policy Recommendation

Overall, Missouri and Missouri cities should lessen their reliance on the more volatile types of taxation by changing the composition of taxes and reorienting taxation policy toward more stable sources. Some researchers have even found that the relative reliance on different tax sources is the most important factor explaining tax-revenue volatility.[17] One implication is that if a government entity increases rates on a more volatile type of tax, any increase in revenue will also be accompanied by greater exposure to revenue swings that could create funding problems in

Figure 5:
Fiscal Year 2019 Total Revenue Breakdown

Missouri and its largest cities rely heavily on volatile sources of tax revenue.



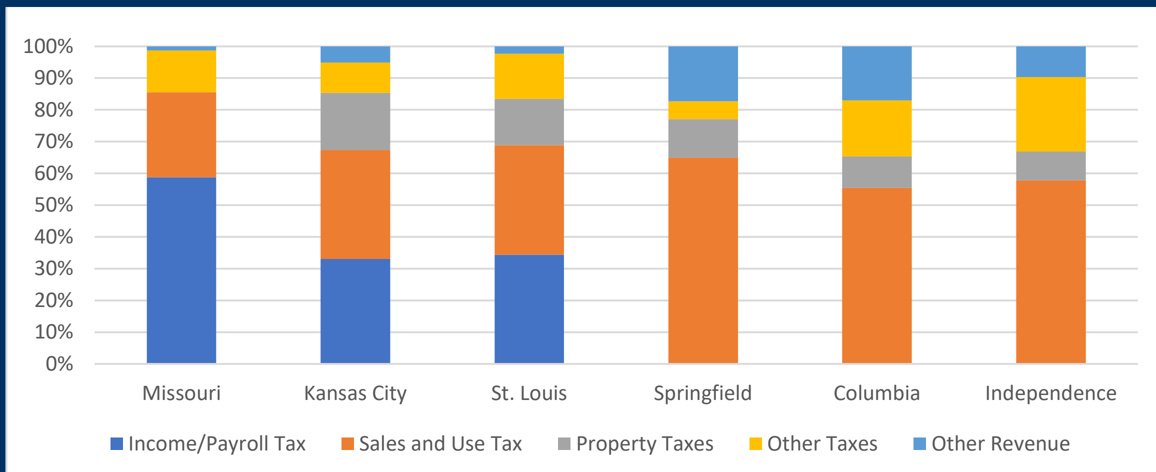
Note: "Other Revenues" may come from charges for services, grants and contributions, investments, and other sources of revenue.

Source: State and City Comprehensive Annual Financial Reports.

Figure 6:

Fiscal Year 2019 General Revenue Breakdown

Missouri and its largest cities rely heavily on volatile sources of income.



Source: State and City Comprehensive Annual Financial Reports for 2019.v

the event of a downturn due to the greater reliance on less stable sources of taxation.

Given the tax revenue volatility hierarchy discussed earlier (income tax revenues are more volatile than sales tax revenues, which are more volatile than property tax revenues), localities could increase the resilience of their budgets in the face of economic shocks by shifting their reliance from income and sales taxes to property taxes, a readily used form of local taxation. Kansas City and St. Louis City especially should transition away from the earnings tax. Not only do income and sales taxes have more negative effects on economic growth than property taxes,[18] but they have more volatile revenue streams, so a lower reliance on these forms of taxation will make revenue streams more resilient against economic shocks. Revenue that may be lost from shifting away from local income and sales taxes could be made up by increasing property taxes and reducing tax incentive programs, in conjunction with other responsible financial practices. These suggestions would give localities a much more stable revenue stream, which is important for successfully combating economic shocks like the COVID-19 pandemic and economic shutdowns.

At the state level, shifting toward reliance on property taxes is not a viable option. However, it would help with revenue volatility to shift away from Missouri's heavy reliance on the income tax. Doing so would bring the state more in line with the rest of the country and would promote economic growth overall. This could be done by shifting toward a reliance on the less-volatile sales tax or making up for lost revenue by reining in or eliminating state tax credit programs.

Though this paper talks about the problematic nature of both income and sales tax revenue volatility, it is worth mentioning that income taxes have larger negative effects on growth than broad-based sales taxes[19] and a broad-based sales tax is often favorable to an income tax. Additionally, this paper does not argue that reliance on property taxes is the best solution for all localities all the time; in fact, Show-Me Institute researchers are often supportive of proper implementation of reasonable sales taxes, as when executed as a user fee.[20] This paper evaluates the tax structure strictly through the lens of an economic crisis.

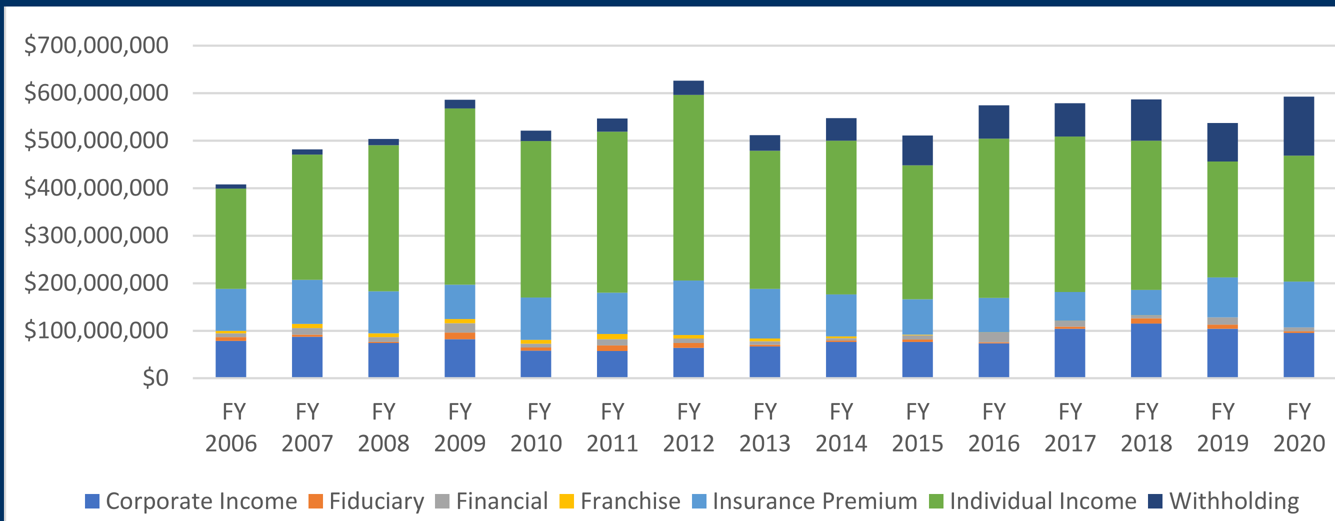
Tax-credit Programs

Revenue volatility not only comes from the composition of taxes that the government relies on but also from policies that erode the tax base or divert tax revenues. One such example is tax credits, which are dollar-for-dollar reductions in the amount of state taxes otherwise owed by taxpayers. These programs drive a wedge between the

Figure 7:

Tax Credit Impact on State Treasury

Missouri's 57 tax-credit programs forego hundreds of millions of tax dollars each fiscal year.



Note: The figure shows the tax category for which each credit was redeemed. Data were not adjusted for inflation.

Source: Missouri Department of Revenue

taxes Missourians pay and the revenues their government receive, which in turn makes it more difficult to fund government services.

Missouri has 57 different tax-credit programs, and each year the state forgoes more than $500 million in tax revenues as the credits are redeemed.[21] Tax credits are similar to other state expenditures in that they reduce the amount of money available for future spending, but they differ in that they are not subject to the usual budgeting process. Once a tax-credit program is created by the General assembly, the yearly toll taken on state revenues and corresponding impact on the rest of the budget can vary greatly.

As Figure 7 shows, yearly tax credit redemptions have fluctuated by more than $100 million over the past decade, with a major uptick in redemptions following the 2008 recession. This volatility is problematic for the state budget because while tax-credit redemptions were increasing by more than 16 percent between fiscal year 2008 and fiscal year 2009, state revenue collections were declining by 6.9 percent. The same can be said for last year when tax-credit redemptions spiked by more than 10 percent between fiscal year 2019 and fiscal year 2020, while revenue collections fell by 6.6 percent. It should also be noted that the majority of credits redeemed each year are claimed against the state's individual income tax.

Historically, Missouri's most expensive tax credits have been the Historic Preservation Tax Credit, the Low-Income Housing Tax Credit, and the Missouri Quality Jobs Tax Credit. These programs subsidize the rehabilitation of old homes, the development of low-income housing, and the creation of jobs by targeted business projects, respectively.

Like other tax incentives, most credits are awarded to encourage some desired activity that lawmakers believe would not occur without government intervention. Multiple state audits and a body of academic research call into serious question the efficacy of many tax-credit programs at achieving the desired effects.[22] However, they remain popular among many lawmakers, who can use them to choose winners and losers by handing out privileges to select companies and then to claim credit for any jobs created regardless of whether they would have been created anyway, how long the jobs last, or which jobs they displace from non-privileged companies that are left footing the higher tax bill necessary to finance tax-credit programs.

The uncertainty of the annual revenue impact of tax-credit programs is a primary concern for the Missouri budget. Once the state awards tax credits, the recipients often have upwards of 10 years to claim their benefit. As a result, Missouri has more than $1 billion in outstanding tax credits that could be redeemed at any time, and even a small increase in claims during a year when state revenues are down would exacerbate an already difficult budgeting problem.

It is also important to remember that every dollar in tax credits redeemed is a dollar that can't be spent on funding other state priorities such as education and public safety. Particularly during an economic downturn, the long-term overuse of tax credits as an economic development tool makes dealing with budgetary shortfalls even more difficult.

Policy Recommendation

One of the best ways to help prepare for the next economic downturn would be for policymakers to take steps to reduce the volatility of tax credit redemptions. When tax credits are awarded, they are approved up to a certain amount of tax liability reduction and are redeemed over a period of years. Let's say, for example, you want to build an affordable housing complex that would qualify for the low-income housing tax credit (LIHTC). If we assume the project will cost $2 million, and you're awarded $1 million in credits, you will then have ten years to redeem them with the potential to reduce your tax liability by $100,000 each year.

The big problem with redemption volatility comes down to the process of claiming these tax benefits. Typically, claiming a tax credit in a given year requires certain stipulations are met. To continue the LIHTC example, if you want to redeem $100,000 in credits, you would need to spend $100,000 on qualified expenditures in that year *and* have a tax liability of $100,000 to get the full benefit of the credit. And since the program has generous carry-forward provisions, like many other Missouri tax credits, if you have spent the requisite amount but don't have sufficient tax liability in a given year you can always carry that balance forward to the following year. This process leads to redemptions that aren't equally dispersed across the life of the awarded credit.

Another wrinkle to the redemption volatility problem is determining how many of the awarded credits will ever be redeemed at all. Many of Missouri's tax credits are issued for projects that will never spend enough, or to recipients who will never have sufficient tax liability to allow them to claim the entire award amount. In general, a successfully completed project that spends less than anticipated is good news for the state, because it means the desired outcome was achieved at less taxpayer expense. Insufficient tax liability, however, poses a different problem. Unlike qualified expenses, which are reported to the issuer of the tax credit, the tax liability of tax-credit holders is unknown until the credit holders actually file their taxes. As a result, it is more difficult for policymakers to predict how many credits will be redeemed based on tax liability.

As if tax credit redemption weren't complicated enough, multiple programs include provisions that allow for the sale and transfer of credits. Allowing such sales helps overcome obstacles to the redemption of credits due to insufficient qualified expenses or tax liability, but also makes forecasting the amount of credits that will be redeemed in a given year even more difficult. Each tax credit program has different rules regarding whom the credits can be sold to and how they can be transferred. In some cases, these rules make certain credits more difficult to redeem. For instance, essentially every LIHTC is sold, because housing developers normally use the credits to raise the capital necessary to finance their approved projects. But LIHTCs are non-transferrable, which means that for someone to be sold a credit, they must have an ownership interest in the awarded project. In practice, the situation becomes extraordinarily complex because the groups that are awarded LIHTCs need to include the developer who can spend the requisite amount, and a sufficient number of investors with enough tax liability to claim all the credits. It should be easy to see how a significant number of tax credits could go unredeemed under such a system.

Compounding these issues across multiple tax credits with various redemption periods and transferability rules has resulted in Missouri having more than a billion dollars in unredeemed tax credits that could be claimed at any time. Such volatility and uncertainty makes budgeting more difficult for policymakers, especially when redemptions could increase during the same time that state revenues are falling.

Changes in tax-credit policy aimed at reducing volatility should be considered alongside more large-scale tax incentive reforms, such as implementing yearly caps, setting aside funds when awarded so they can be accounted for until redeemed, stricter testing guidelines for eligibility, or eliminating programs altogether. Reducing the number of years credit holders can wait before redeeming their credits would decrease volatility without making any of the broader reforms less effective.

EXPENDITURE VOLATILITY

State government expenditures are greatly influenced by economic conditions because of the role states play in administering safety net programs. State and federal laws determine the eligibility criteria for these programs, some of which are considered entitlements that those who qualify for must be allowed to receive regardless of whether the government has the money to pay for them.

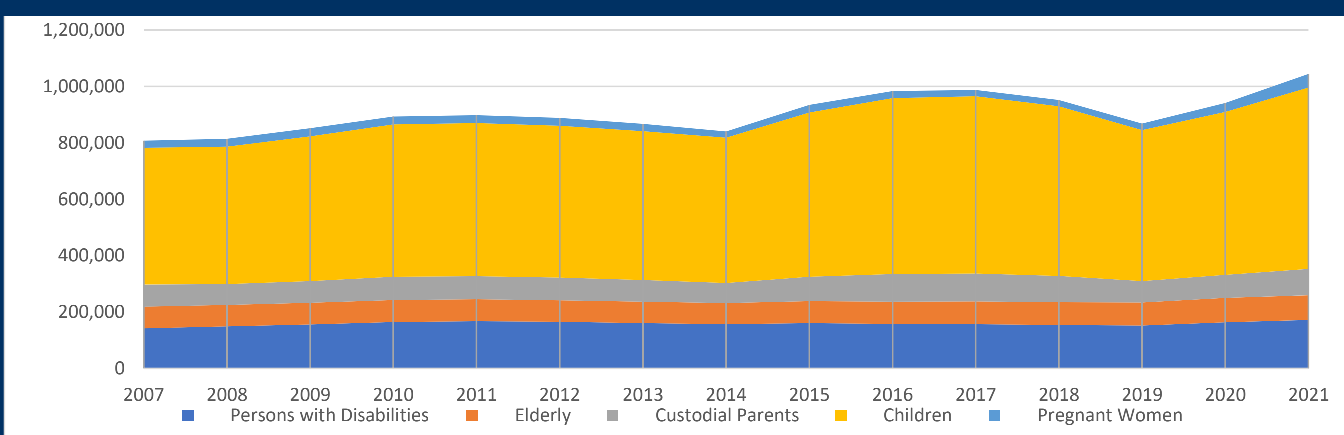
This dynamic can lead to significant budgetary problems when facing a recession because one of the biggest entitlements, Medicaid, behaves countercyclically—meaning that costs are expected to increase when economic conditions decline. In other words, costs rise at precisely the time when states subject to balanced budget rules have the least amount of money.

Medicaid

Medicaid is the largest non-contributory entitlement program in the country, it is the single most expensive item in Missouri's budget, and it is responsible for some of the largest increases in automatic spending during downturns. The program is a state–federal partnership that finances health coverage and long-term care services for low-income individuals.

Figure 8:
Missouri Medicaid Enrollment

Enrollment in Missouri's Medicaid program has grown significantly since the beginning of the COVID-19 pandemic.



Source: Missouri Department of Social Services

Prior to the COVID-19 pandemic, Missouri's Medicaid program had approximately 850,000 enrollees, but that total has since skyrocketed.[23] By October 2020, program enrollment eclipsed one million Missourians for the first time ever and has kept increasing each successive month since (Figure 8). Research has shown that enrollment is the primary driver of program costs, so the past year's spike in enrollees has correspondingly increased the program's spending.[24]

In addition to Medicaid's countercyclical nature, public policy decisions can significantly impact the magnitude of its expenditure volatility. Because it's a state–federal partnership, the federal government sets the minimum eligibility guidelines for the program and mandates certain health services be covered. In exchange for the state meeting these requirements, the federal government agrees to pay a percentage of all Medicaid costs, which for Missouri has historically been around 65 percent.[25] Like many other states, however, Missouri has requested and received approval to make some aspects of its eligibility criteria more lenient and benefits more generous than the federal minimum, with the federal government covering some but not all of the resulting increase in costs (Figure 9).

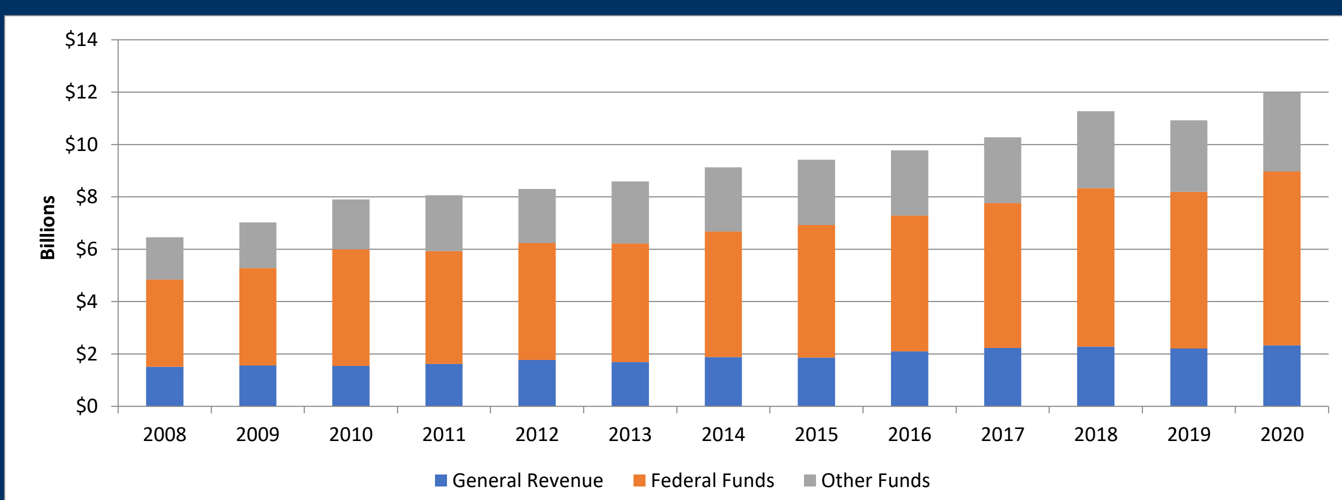
Although Missouri's eligibility criteria for healthy adults are among the most stringent in the country, they are extremely lenient for children. Healthy adults without dependents do not qualify for Missouri's program regardless of their income. And those with dependents must make less than 22 percent of the federal poverty level, which is approximately $2,800 per year. For children, only eight states in the country have more lenient eligibility criteria than Missouri. To qualify, children's families can make up to 305 percent of the federal poverty level, which is around $79,000 per year for a family of four.[26]

Unsurprisingly, as Figure 8 shows, the majority of enrollment growth during the COVID-19 pandemic has been among children. When parents lose their jobs or source of income, their children will be the first ones to qualify for Medicaid. As of March 2021, approximately 48 percent of Missouri's population aged 18 and under were enrolled in the state's Medicaid program.[27]

Missouri's Medicaid program also covers a more generous set of benefits than many other states. For instance, every state program offers pharmacy benefits even though the federal government doesn't require it, but Missouri is

Figure 9:
Total State Medicaid Spending

Between 2008 and 2020, the cost of Missouri's Medicaid program nearly doubled.



Source: Missouri House of Representatives Budget Fast Facts one of only 24 states that cover chiropractic care.[28] These additional covered services increase the monthly cost of each enrollee, because the majority of Missouri's Medicaid enrollees are covered under what are called managed care plans. These plans function similarly to private insurance where the state pays insurers monthly to cover whatever costs are incurred for state-approved services by those enrolled in the program. Therefore, anything that increases the monthly premium for coverage also leads to higher spending volatility when enrollment changes. As of 2018, Missouri spent the 12th most per Medicaid enrollee of any state in the country.[29]

Taken together, it's easy to see how Moody's came to its estimate of Missouri having the 8th-highest increase in Medicaid spending. State eligibility guidelines make it easy for enrollment to skyrocket during a recession, and once participants enroll, Missouri pays more for their coverage than most other states in the country.

Policy Recommendation

It should be noted that during the pandemic, and after Moody's conducted its analysis, Missouri voters approved a petition to expand the state's Medicaid program. This constitutional amendment is expected to increase the program's enrollment by more than 200,000 in the first year by extending coverage to healthy adults who do not currently qualify. Expansion is set to be implemented in July 2021, but because of the uncertainty surrounding how it could impact Missouri's recession preparedness and the potential for constitutional issues with various reform efforts, this report will not include any policy recommendations relating to the state's Medicaid program.

MISSOURI'S BUDGET RESERVE FUND

The previous sections explain the difficult situation Missouri finds itself in, with policy decisions at the taxation and spending levels leading to greater volatility of government finances in downturns. In principle, one of the primary ways that states prepare for such fiscal volatility is to save funds when times are good so that the money is available during leaner times. In Missouri, the fund established for this purpose is called the Budget Reserve Fund (BRF) and was established in 1999 under the state's constitution.[30] Passed as a supposed improvement upon previous iterations of the same idea, the constitutional provision outlines specifically how much money the BRF can contain and the situations in which it can be used.

For funding, the BRF balance must be 7.5 percent of the state's net yearly revenue collections (including any amounts owed to the fund) by the end of each fiscal year, which for 2019 totaled approximately $650 million. To put the amount in context, Missouri typically expends around $10 billion per year from state tax revenues. This balance ranks Missouri in the bottom half of all states for available rainy-day funds.[31]

The Missouri Constitution also stipulates that if the balance is too low, funds will be transferred from the state's general fund to reach the 7.5 percent threshold (minus whatever is owed to the fund). If the balance exceeds the 7.5 percent threshold, the excess will be transferred back into general revenues, unless such excess is a result of the legislature appropriating funds to increase the fund's balance. But if the balance ever gets above 10 percent of net yearly revenue collections, notwithstanding any efforts to increase the fund's balance, the excess will be transferred back into general revenues.[32]

The BRF was created to serve two purposes:

1. To provide short-term liquidity. Even with a balanced budget, the precise timing of revenue receipts and spending needs may not perfectly align at any given point during the fiscal year, leading to potential cash flow shortages (or surpluses). When a temporary cash infusion is needed to cover short-term funding gaps, the state's budget administrator can authorize use of the BRF. In this case, the amount borrowed must be repaid before May 16 of the current fiscal year, which also means the fund cannot be used for these purposes between May 16 and June 30 each year.

2. To provide budget stabilization in the event of an unanticipated fall in year-end revenues or unavoidable increase in expenditures. In this case, access to the BRF is subject to strict conditions.

First, the governor must have declared a state of emergency, or state expenditures must have been reduced below their originally budgeted amounts (which would happen in the case of a revenue shortfall in an effort to keep the budget balanced). Then the governor must request an emergency appropriation from the fund by the general assembly for budget stabilization purposes.

a. Next, the general assembly must approve the use of the BRF for budget stabilization purposes by a two-thirds majority. Even if stabilization is approved, only half of the BRF's balance can be used for stabilization, which includes the current balance in the fund and any amount appropriated to or otherwise owed to the fund. The only potential funds not included in this calculation are those that are owed to the fund as a result of prior use for budget stabilization purposes but not yet appropriated to be repaid.

b. Once funds are approved and used for this purpose, at least one third of the amount borrowed must be repaid by the following July 15, including whatever interest would have been earned, for the next three years until fully repaid.

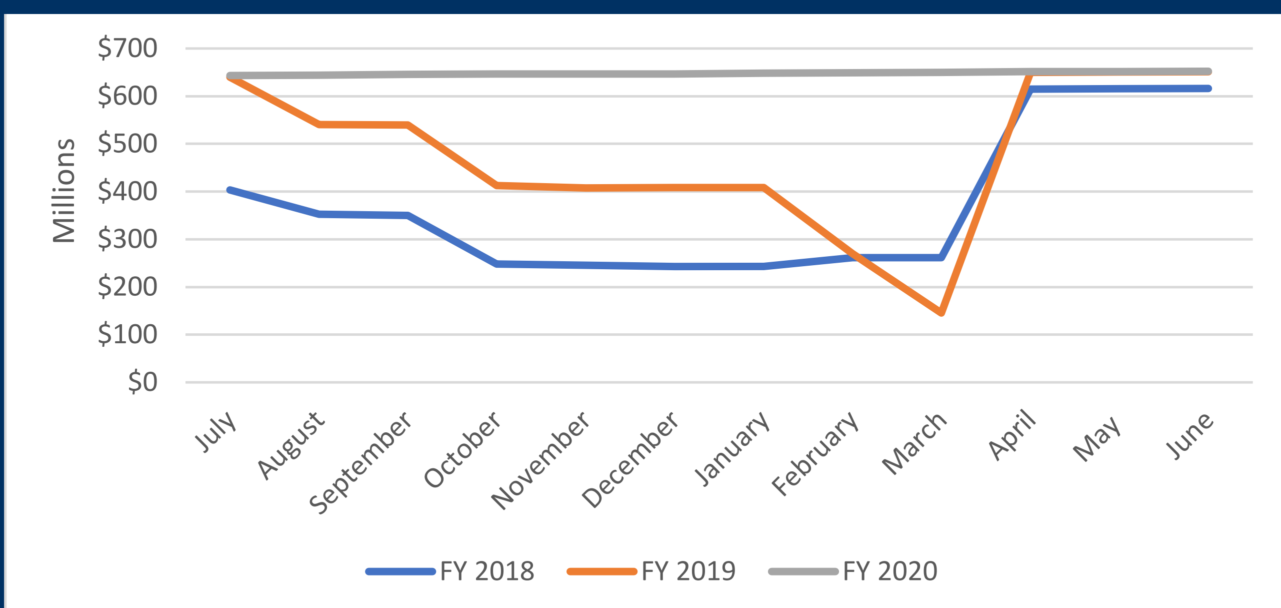
The final point about half of the BRF balance being available for budget stabilization is an important one. Because the most common use of the fund is its first purpose—providing short-term liquidity—the actual balance is likely to be much lower than the fund's year-end required balance (Figure 10). This means that while the general assembly may be able to appropriate more funds for budget stabilization than are currently available, the use of funds for stabilization in excess of the fund's balance would be problematic in practice.

Remember, the only reason the governor would call for the use of the BRF for budget stabilization purposes would be if there were not enough general revenue to get through the end of the fiscal year. By appropriating spending

Figure 10:

Budget Reserve Fund Balance

For the greater part of most state fiscal years, the budget reserve fund's balance is much lower than the amount it starts and ends with.



Note: For the greater part of most fiscal years, the budget reserve fund's balance is much lower than the amount it starts and ends with.

Source: Missouri State Treasurer's Office above the currently available balance of the fund, budget stabilization would create its own cash flow problem, thus minimizing its value. A Moody's Analytics stress-test estimating the impact of the pandemic-induced recession revealed a pair of harsh truths about the state's BRF.

First, the balance of the BRF is simply too low to address budget stabilization concerns. When comparing the report's estimated fiscal shock (decreased tax revenues and increased Medicaid costs) to the BRF's balance, the difference shows Missouri could be short by more than an estimated $2 billion.[33] And since the BRF balance is typically lower than what was included in Moody's analysis because it used the end of state fiscal year total (when also taking into account that only half can be used for budget stabilization purposes), the fund is likely even less useful in practice.

Second, the funds are too hard to access and even more difficult to repay. Quick government action is often necessary during an economic downturn. Missouri's general assembly is only in session for five months of the year, and getting two-thirds approval from both chambers is never a simple task. In addition, the repayment terms for using the BRF could be harmful during a prolonged recession. For example, the 2008 recession lasted 18 months, yet Missouri's tax revenues didn't recover to their prior levels for five years. Borrowing from the BRF to help in that budget crunch would have required full repayment at a time when revenues were even lower than the time at which the funds were requested in the first place.[34]

Taken together, the restrictions surrounding the use of the BRF effectively ensure the funds are unavailable for use during budget shortfalls. In fact, since the BRF was established, it has never been called upon for this purpose.

Policy Recommendation

One of the best ways Missouri's legislature can prepare the state's budget for the next economic downturn is to make changes to the BRF. It is Missouri's only fund that was designed to be used when the state needs money, yet it has never been called upon for budget stabilization purposes because of the various rules restricting its use.

First, the allowable balance of the fund should be increased based on the anticipated revenues needed during an average recession. During the two fiscal years following the 2008 recession, Missouri's tax revenues fell by more than $1.2 billion. Thus, even if the state's BRF was at its constitutional maximum of approximately $650 million, and the entire balance could be used to help with the budget, there still would have been a shortfall of nearly $600 million.

Second, the legislature should enact new rules for withdrawal that make the funds more easily accessible during a fiscal crisis. Limiting the amount of funds available for budget stabilization purposes to half the balance exacerbates the problem of the BRF being too small. Today, the main purpose of the fund is to provide cash flow liquidity assistance, so there are times throughout the year where the balance has dropped as low as $145 million. Not only would half that balance barely make a dent in a recession-induced shortfall, but removing those funds to stabilize the budget could leave insufficient funds available for necessary cash flow.

Third, the terms of repayment to the fund should be changed so that its use for budget stabilization purposes during an economic downturn doesn't negatively impact the state's economic recovery. When Missouri was last hit by a recession, the state's revenue collections didn't return to pre-recession levels for more than five fiscal years. Requiring that one third of the amount borrowed be repaid with interest by the next July 15 disincentivizes borrowing from the fund in the first place but will also necessitate more severe cuts to the state's budget to accommodate the repayment. To ensure that the Missouri's own reserve fund repayment policy doesn't hamper the state's recovery, the pace of repayment should be tied to the speed of recovery in underlying economic or revenue indicators such as the state's GDP, unemployment, or tax receipts.

Finally, it may be that the best possible path toward improving Missouri's rainy-day fund is for the legislature to establish something entirely new. Policymakers could keep the BRF in place in its current role as the preferred source for cash flow assistance. By creating a new plan for dealing with economic downturns, our elected officials could decide how best to build a rainy-day fund when economic times are good and determine what terms need to be met for withdrawal. No matter what the legislature decides, it is clear that the rules surrounding Missouri's current BRF are making it difficult for the state to respond to economic downturns.

COVID-19: A YEAR LATER

The COVID-19 pandemic downturn has been extremely unusual relative to past recessions, both in terms of the nature of the shock and the response of the federal government in providing aid. Together, these differences have substantial fiscal implications for state and local finances. Regarding the shock itself, the presence of stay-at-home orders and fear related to the virus caused a percentage drop in consumer spending almost five times as large as that during the 2007–09 Great Recession.[35] This drop in spending, in turn, negatively impacted sales tax revenues. Moreover, the pandemic accelerated the shift toward online sales, which Missouri to date has not yet taxed.

Switching to the case of income taxes, one would normally expect receipts to plunge in the face of a 12.5 percent unemployment rate back in April 2020, but the historically large federal rescue packages actually caused a substantial rise in disposable income—an anomaly from past recessions—in large part because of generous unemployment benefits that for most workers replaced more than 100 percent of lost wages.[35] Because Missouri taxes unemployment benefits, it's not clear to what extent personal income tax revenues will end up suffering. The federal government has also provided hundreds of billions of dollars to state and local governments to offset pandemic-related expenses and, more recently, revenue losses.[36] In fact, 48 of 50 states, including Missouri, received more in federal aid than they are likely to lose in revenues.[37] As a result, states and localities have been shielded from the consequences of their own budgeting practices, leaving many lawmakers pleasantly surprised by new budget outlooks.[38] In short, the nature of the pandemic shock and the outsized federal response make it difficult to extrapolate into the future. There is no way to know how the federal government will respond to a future downturn, and thus it is still up to Missouri state and local governments to put plans in place to ensure resilient budgeting during future hard times.

CONCLUSION

Missouri and its cities were not ready for the current pandemic and resulting economic downturn, but the good news is that there are steps that can be taken to better prepare for the future. Inevitably, Missouri will experience economic shocks and see periods of economic decline. Public policies play an important role in preparing for and reacting to these situations. The reforms presented in this paper would make the state and localities better able to deal with future economic downturns, and perhaps more importantly, the recoveries that follow.

Reducing Missouri and its cities' reliance on the more volatile forms of taxation, such as sales and income taxes, would help lessen the steep revenue declines governments experience during times of economic hardship. Lowering income and sales taxes would make Missouri more attractive to businesses and people. These policies also have the benefit of positively impacting economic growth in times that are both good and bad, which helps accelerate recovery after a downturn.

State and local governments should also rein in their rampant overuse of tax incentives. Tax credits award government-chosen winners with future tax revenues to the present and future detriment of other state funding priorities. Research has repeatedly shown that such policies provide, at best, questionable benefits during normal economic times but can be quite detrimental when fiscal crises arise.

Missouri's legislature should also take the steps necessary to fix the state's rainy-day fund. No matter how much is done to limit revenue volatility or rein in tax incentives, an economic downturn will still lead to governments with declining revenues while costs are increasing. That's why it's essential that Missouri begin building a more substantial rainy-day fund when the economy is healthy and make the changes necessary to allow those to funds be accessed when a recession-induced shortfall needs to be filled.

Taken together, the proposals described here would boost Missouri's economy, make its state and local governments more efficient, and provide the budgetary resources necessary to be better prepared for and recover faster from the next recession. The effects of COVID-19 will likely be felt by Missourians for years to come, and it's imperative that state and local officials adopt policies now to be better prepared for the economic shocks of the future.

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