

JEL Classification Numbers  
E62, H72

Summary of  
WP/92/112

"U.S. State and Local Government Finances  
over the Current Cycle" by Tamim A. Bayoumi

The recent slowdown in the U.S. economy led to significant budgetary problems for the state and local government sector, resulting in well-publicized tax increases and expenditure cuts, while during the 1985-89 economic expansion the fiscal balance of state and local governments in the United States steadily deteriorated. Thus, the sector amplified both the upswing and the downswing in activity in the current cycle. This paper looks at whether this behavior is typical and, if not, what might explain the difference this time around.

Comparing the most recent cycle with others, this paper concludes that the period since 1985 differs from earlier cycles in the 1970s and 1980s. In the earlier periods, the fiscal balance deteriorated during downturns and rose during recoveries, providing a significant part of government automatic stabilizers.

The immediate cause of the recent fiscal problems lies in the interaction between the low level of reserves accumulated over the upswing and existing laws requiring balanced budgets. For example, in mid-1980, before the two recessions of the early 1980s, state general government cash balances were 9 percent of expenditure; in mid-1989, by contrast, they were less than 5 percent. A similar pattern is evident for local government. As a result, the 1990-92 slowdown forced state and local governments to improve their financial position, undermining their role in stabilizing the economy.

But what explains this failure to build up reserves? Several possibilities are examined, including the role of federal government grants, federal mandates, tax revolts, and compensation to labor. The evidence indicates that the first three factors played little role in changing behavior, but that a large change in relative compensation over the 1980s was important. Between 1984 and 1990, this rise in relative compensation raised state and local government spending by almost \$30 billion, equal to the whole of the deterioration in the fiscal balance over the period.

As a result of these developments, the state and local government sector will need to continue to cut services and raise revenues in the short term. Over the longer term, the question is whether the sector will resume the pattern of the 1970s and early 1980s or whether it will continue to act as it did in the late 1980s. On the whole, the evidence points to the former. Although external factors, such as rising Medicaid payments, may cause continued fiscal strain, they have not been the core of the problem. The current fiscal squeeze, with its pressure to control costs, including labor costs, may well improve the longer-run financial outlook for the sector, enabling it to resume the countercyclical behavior of the 1970s and early 1980s.