

ECONOMIC COMMENTARY

by

Stephen P. A. Brown

Assistant Vice President and

Senior Economist

Federal Reserve Bank of Dallas

A Balancing Act for State and Local Governments

Many state and local governments throughout the United States face budgetary shortfalls. Some of the shortfalls are cyclical, meaning that they result from the recent recession. Some of the shortfalls are structural, meaning that they result from factors other than the recent recession, such as a permanent erosion of the tax base or increases in the proposed level of government spending.

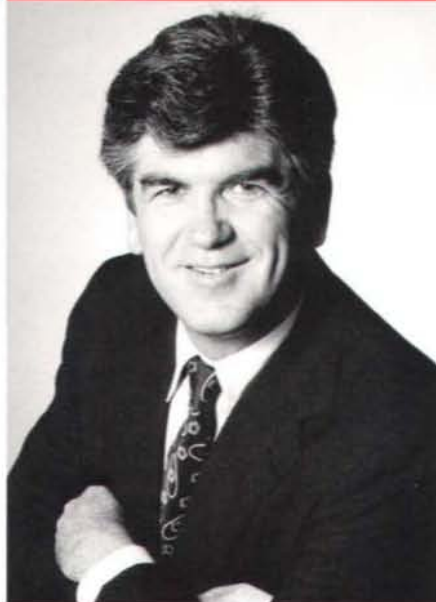
Unlike the federal government, most state and local governments have constitutional prohibitions against running budgetary deficits. So, those governments facing shortfalls must cut their spending or increase their taxation. How each state and local government balances its budget could affect future economic growth in its jurisdiction. A stable fiscal policy that balances state and local government spending against taxes on businesses and individuals can help attract and retain the business investment and work force necessary for sustained economic growth.

Cutting Spending or Increasing Taxes?

The desirability of cutting spending or increasing taxes varies from case to case. For some state and local governments, spending cuts may be the best way to close budgetary shortfalls. For others, increased taxation may be best. When the additional revenue from tax hikes finances enhanced public services in a region, the improvement in services may more than offset the harmful effects of higher taxes.

If a government is not growing too fast relative to the taxpayers' ability to pay, increased taxation to support enhanced government services can stimulate economic growth. As the government grows relative to the taxpayers' ability to pay, however, the value of additional government spending declines. Beyond a certain point, the value of additional government spending falls below the taxes required to support it. Once a state or local government reaches this point, further increases in spending retard economic growth in the region. Thus, one of the most important questions to ask about state or local fiscal policy is whether it is likely to maintain a stable relationship between the growth of government spending and the taxpayers' ability to pay.

Two essential elements of maintaining that stable relationship are meeting cyclical shortfalls with temporary measures and structural shortfalls with permanent mea-



asures. A government's use of permanent tax increases or spending cuts to meet cyclical shortfalls could harm future economic growth in its jurisdiction. So could its use of temporary tax increases or spending cuts to meet structural shortfalls.

Closing Cyclical Shortfalls

For many state and local governments, the recent recession brought cyclical shortfalls. Economic recovery will boost revenue while allowing these governments to reduce spending on social programs. Until the economy has recovered sufficiently, temporary spending cuts (which typically prove difficult to make during an economic downturn) or temporary tax increases can be used to

close the budget shortfalls.

Nonetheless, some state and local governments may choose permanent tax increases to close their cyclical shortfalls. Such increases could lead to excessive growth of government and, consequently, to reduced economic growth. As the nation's economy improves, the governments that have adopted permanent tax increases to meet cyclical shortfalls will run budgetary surpluses. If history is a guide, the surpluses are likely to foster sharp increases in their spending. Over the business cycle, the growth of their spending will exceed that of the taxpayers' ability to pay. In regions where this occurs, the value of additional government services could fall below the taxes needed to fund them, and economic growth could be slowed.

Closing Structural Shortfalls

Some state and local governments face structural shortfalls that economic recovery will not close. These governments must enact permanent cuts in spending or increases in taxation to balance their budgets over the long run.

Unfortunately, some governments may use stop-gap measures to temporarily close their structural shortfalls. Such an approach could prove harmful to the region's economic growth. Among other things, economic growth depends on planning and investment for the future. Stop-gap measures leave individuals and firms uncertain about future taxes and future government services. That uncertainty interferes with the ability of potential taxpayers to plan and invest for the future, and in doing so, harms economic growth.