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Understanding State and Local Government Spending over the Business Cycle

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Since the mid-1980s, state and local government spending has followed a consistently procyclical pattern, declining during recessions.

State and local (S&L) government spending is essential for providing public services and infrastructure and accounts for more than 10 percent of GDP. How this sector responds during a recession can play an important role in shaping the overall economic recovery.

Huixin Bi, Chaitri Gulati, and Nora Traum document how S&L government expenditures have evolved over the business cycle since the 1950s. They find that from 1950 to the mid-1980s, S&L spending followed no uniform pattern after recessions: spending was sometimes procyclical (declining during recessions) and sometimes countercyclical (rising during recessions). However, since the mid-1980s, S&L spending has followed a consistently procyclical pattern, beginning to recover three years, on average, after the start of a recession. This shift seems consistent with changes in the cyclical nature of income tax revenues, which not only became consistently procyclical in the mid-1980s but have also become a larger share of total tax revenues. These results suggest that income tax revenue adjustments are particularly important in accounting for recoveries in the S&L public sector.

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