Understanding State and Local Government Spending over the Business Cycle

by: Huixin Bi, Chaitri Gulati and Nora Traum

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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 cyclicity 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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Huixin Bi
Research and Policy Officer

Huixin Bi is a Research and Policy Officer in the Economic Research Department of the Federal Reserve Bank of Kansas City. Previously, Ms. Bi served as an economist at the Bank of Canada from 2010 to 2015. Her main areas of research are fiscal policy, sovereign debt and computational economics. She holds a B.S. in engineering from Nankai University in China, a M.S. in engineering at Rose-Hulman Institute of Technology, and a Ph.D. in economics from Indiana University.