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RESEARCH SUMMARY

STATE FISCAL CRISES
States' Abilities to Withstand Recessions

During recessions, states often face budget shortfalls. Some observers believe that these fiscal crises are outside policymakers' control if there is a declining national economy or if there have been reductions in federal aid. Others believe that if state governments increase the size of their rainy day funds, implement large tax cuts, or avoid enacting large spending increases during nonrecession years, budget shortfalls may be limited.

In a new empirical study of state-level fiscal data for the Mercatus Center at George Mason University, economists David T. Mitchell and Dean Stansel examine these competing hypotheses and conclude that fiscal stress at the state level is positively correlated with spending growth and negatively correlated with the size of the state's rainy day fund. This study shows that policymakers have greater control over the fate of their states' finances than they may believe. Spending restraint, tax cuts, and increasing the size of rainy day funds are sound strategies for minimizing future fiscal stress.

SPENDING AND SAVING IMPACTS FISCAL HEALTH

Policymakers face three basic (nonexclusive) options when there is extra revenue during nonrecession years:

- Use the revenue to increase spending by expanding existing programs or initiating new ones.
- Return the revenue to the taxpayers through tax cuts.
- Deposit the excess revenue in a rainy day fund.

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DATA AND KEY FINDINGS

The study estimates fiscal stress as a function of the growth in real per capita state spending, the size of the state rainy day fund (also in real per capita terms), unemployment, union membership, Medicaid spending growth, gross state product, and federal grants.

Examining state-level data for these variables using different econometric methods, the study shows that state fiscal stress is associated with spending growth and the size of rainy day funds, but not with the unemployment rate or federal aid.

- *Spending growth.* State fiscal stress is positively associated with spending growth. The more a state spends, the more likely it is to incur fiscal stress during a recession.
- *Rainy day funds.* State fiscal stress is negatively associated with the size of rainy day funds. The less a state saves for future fiscal crises, the more difficult the crises are likely to be.
- *Unemployment and federal aid.* State fiscal stress is not significantly associated with either the unemployment rate or federal aid.

CONCLUSION

History shows that when times are good and revenue is increasing, states that use those windfalls to increase spending tend to face more budget problems during the next recession. Policymakers should resist the temptation to spend that excess revenue in order to help minimize the fiscal stress the state will face in the next recession. Just like families, governments need to avoid squandering resources and instead save for a rainy day.