

Chapter 2

From Economic Stabilization to Budget Stabilization

Abstract This chapter starts with an introduction to the concept of the economic cycle and how Mankind has been coping with economic fluctuations; then it traces the evolution of the stabilization function of government: How this function was started and theorized as a necessary addition to the allocation and distribution functions and why fiscal policy is always necessary besides monetary policy. Section 2.2 discusses economic stabilization at the central level. This role carries with it some inherent problems, in particular three types of lag – those in identifying recessions, in taking policy actions, and in obtaining the designed effects of the policies. What is the core of the debate about the efficacy of the stabilization function and why such policy has long been practiced despite the absence of consensus? Section 2.3 elaborates on why the stabilization function that had long been assumed to be exercised solely by the central government was extended to the subnational level and how state governments in the USA experimented with their fiscal practices. The chapter concludes that the stabilization function at the subnational level is best taken as budget stabilization for smooth provision of public services across the economic cycle.

2.1 The Stabilization Function of Government: An Overview

Boom-bust cycles are a natural phenomenon that is inherent in the economy. Despite decades of intensive academic and policy studies, economic cycles still “stubbornly” defy human mastery to remain unavoidable, even incomprehensible. The Great Recession of 2007–2009 played a joke with the overoptimistic assumption that was raised just a few years before that the era of recessions was over. The Great Recession reminds the policy and research communities again that the inherent, not-yet-mastered forces of the market and the economy are still “at large,” defying easy control, and that we must pay due and adequate attention to them. It was revealed after the onset of the Great Recession that economic forecasts conducted with the most sophisticated models, and the most advanced computing power turned out to be guesstimates; a major recession can still render the economy as volatile as ever.

Recessions, however, can be taken on the positive side as signals and occasions for correction of errors accumulated in the expansionary phase of the economic cycle; the corrective action is reallocation of resources in the macroeconomy, most of which can and should be done through the market mechanism in the most efficient fashion. But reallocation may be accompanied by drastic economic decline during downturns that necessarily causes tremendous disruptions to existing productivity as well as the normal standards of living. Amelioration of such disruption is often beyond the concern and the capacity of the private sector; it falls at least partly, if not squarely, on the public sector as the function of macroeconomic stabilization.

2.1.1 *Economic Cycle*

According to the *Webster's Collegiate Dictionary*, a cycle is (a) “an interval of time during which a sequence of recurring succession of events is completed”; and (b) “a course of events that recur regularly and usually lead back to the starting point.” Regular cycles are predictable ones; they are observable in our daily lives, days, and years being typical examples. Irregular cycles are unpredictable, thus imposing uncertainty onto human lives. Examples of irregular cycles include agricultural harvests that are unusually rich or poor due from climate conditions in any particular year and performance of the macroeconomy that is either in a boom or a recession. In this book we focus on the latter example. Irregular economic cycles with high degrees of uncertainty cause disruptions to productivity, public services, and our daily lives. Fluctuations of the economy are first and foremost related to businesses, and the private sector provides most of the jobs and income to the majority of the general public. Therefore, these cycles are also referred to as the “business cycle” in the academic literature.

Each economic cycle is divided into two broadly termed phases, “expansion” and “contraction.” An expansion starts when the economy has hit the bottom during a recession, called the “trough”; at that point, key indicators like output and employment stop decline and begin to rise. Expansion will continue till the economy has reached its highest point, called the “peak”; then key indicators show signs of decline. Output will shrink and unemployment tips up, starting the contraction phase. Typically, expansions are longer than contractions. The exact dates of the turning points between the two phases are not known until the economy has developed further along its course. The National Bureau of Economic Research (NBER) has a Business Cycle Dating Committee, a panel of distinguished macroeconomists, who track the key indicators on a monthly basis and determine ex post the dates of transition between the two alternating phases.

The study of economic cycles has a history almost as long as the market economy in the Western world, because periodic shocks to the economy – recessions – were a repeated frustration and perplexity to business owners and executives, elected officials and scholars, which pressed for explanations, answers, and solutions. In fact Mankind has been dealing with the cycle of rich and poor harvest years since

the beginning of agriculture. The rich versus poor harvest years are the cycles of the nature reflected in the output of agricultural activity. Out of centuries' experience, some commonsense insight accumulated. Long-standing is the teaching to "save grains in case of famine." Lessons like this are recorded in our history. In *The Bible, Old Testament, Genesis*, Chapter 41, we have:

The King had a dream that he could not understand; so he summoned his wise advisors for interpretations. Among those was Joseph who foresaw a famine. Joseph got approval from the King to purchase and store grain in seven years of good harvests in a row. Then seven years of famine followed. The stored food enabled Egypt to feed its people, with some surplus to help refugees.

Similar records are also seen in ancient history of other civilizations. In the Zhou Dynasty of ancient China, each year's harvest was divided into four equal parts, with three parts for current year consumption and one part for savings; thus, saving one part for 3 years would have accumulated enough grain to last for one more year. Then taking 30 years as a long fiscal cycle, the nation would have accumulated enough savings to last for another 10 years.¹ In an ancient Chinese history book (*The Book of Rituals* or *Li Ji*), we see the following:

For a nation, it is inadequate without enough savings to last for nine years; it is emergency without enough to last for six years; and the nation would no longer be a nation without enough to last for three years.²

As Mankind entered the era of Industrial Revolution in the mid-eighteenth century, dramatic improvement of productivity and continuous, substantial increase of the overall economy both enlarged the cyclical fluctuations of the economy and made such fluctuations more acutely felt, with increasingly more damage to productivity and human lives. Thereby, the need to better handle such economic shocks had become increasingly urgent.

2.1.2 Evolution of Theory

In his 1985 article on the "Fiscal Science," Richard Musgrave traces the evolution of economic theory on stabilization to the mercantilists. Sir James Steuart in his (1767) *An Inquiry into the Principles of Political Economy* said: Stagnant money "lent to government is thrown into a new channel of circulation, thereby to augment the prominent income of the country."³ By Jean Baptiste Say's (1821) Law: Since commodities exchange against commodities, supply would create its own demand.

¹ This is quoted from Du and Fang (1992, 371). The original in Chinese is: 周朝把“每年的收成分成四份, 用其三而储其一; 每年余一, 三年余三, 即三年储备可供一年之用; 以三十年为一大财政年, 则有十年之蓄。”

² The original in Chinese is: 《礼记-王制篇》载, “国无九年之蓄, 曰不足; 无六年之蓄, 曰急; 无三年之蓄, 曰国非其国也。”

³ Vol. II, 642, 644, quoted from Musgrave 1985, 45.

Thomas Robert Malthus in his (1824) *Principles of Political Economy* analyzed the causes of recession to a chain of actions from diminishing demand to unemployment to market depression. He offered budget policy as a possible solution for deficient consumer demand through redistribution of income (via taxation). These were the early Keynesians. Musgrave concludes that economic theory till the 1930s distinguished mainly two kinds of effects from budget policy, alternative use of resources, and distribution of income that he had termed as the “allocation function” and the “distribution function” of government in his (1959) *Theory of Public Finance*. Indeed, the dominant economic philosophy in America prior to the 1930s had long been the Jeffersonian ideal of the least possible interference by government with the private economy (Hansen 1941, 110). In the 1930s, the work of John Maynard Keynes introduced the later dubbed “Keynesian Revolution” that treated aggregate demand as a major determinant of the level of employment. With this development, the stabilization function was added to the other two functions of budget policy (Musgrave 1985, 44).

The introduction of Keynesianism led to the emergence of the theory and practice of “countercyclical fiscal policy” (CCFP). Keynes’ breakthrough was his emphasis on using fiscal policies to stimulate aggregate demand during recessions. In the 1930s, American fiscal policy “moved into the center of macro economics” (Musgrave 1985, 44). The unprecedented devastating effects of the Great Depression on the national economy pushed scholars to thoroughly reexamine economic policies, both monetary and fiscal, by the federal, state, and local governments. Scholars were shocked to find that all levels of government till then had been following the waves of the economic cycle, spending more during booms and cutting back during recessions, especially during the Great Depression. The reason was, at least partly, due from the noninterference tradition carried over from the Jeffersonian philosophy and the binding requirement to balance the budget annually at each and all levels of government. Table 2.1 cites examples from Hansen and Perloff’s (1944) study which found that the federal sales taxes in 1933 were in fact heavier than in 1931 and that when the federal government increased public expenditure during the depth of the Great Depression, states and localities reduced their expenditure, thus mitigating the effects of the federal expansionary policy.

In a 1932 paper, Simeon E. Leland of the University of Chicago studied how the public sector could better meet the challenges imposed by financial crises. He found fault with the fiscal year, arguing that the annual budget cycles did not consider the cyclical fluctuations of the economy. He therefore called for financial programs longer than the fiscal year to constitute a wiser fiscal policy (Leland 1932). His proposal was discussed in the following year by a University of Chicago roundtable (of which Leland was a key member) as a method the federal government could use to balance the budget over the economic cycle. Results of the roundtable were three points. An overall idea was to take budget balancing as consecutive long-term operations that are designed to strike equilibrium between revenues and expenditures not by the fiscal year but over a number of years, a full economic cycle. During the bust years, deficits will incur and debts thus increase as a result of government efforts to stimulate the aggregate demand; then during the boom years, surpluses

Table 2.1 Federal, state, and local fiscal policy indices 1928–1939 (Figures are in millions of nominal dollars)

FY	Net income-increasing expenditures		Expenditures for new public construction		Taxes on sales	
	Federal	State and local	Federal	State and local	Federal	State and local
1928	–77	810	188	2,104	1,054	NA
1929	–232	928	188	2,104	1,065	NA
1930	388	1,221	307	2,469	1,060	NA
1931	2,419	1,291	422	2,156	839	538
1932	1,797	676	460	1,334	739	560
1933	1,809	–705	647	707	961	550
1934	3,460	–1,165	1,380	794	1,404	806
1935	3,568	–657	1,234	616	1,573	964
1936	4,374	–450	2,335	881	1,794	1,229
1937	1,114	–244	2,043	845	2,104	1,406
1938	2,225	–321	2,139	1,089	1,935	1,508
1939	3,581	209			1,905	1,530

Source: Hansen and Perloff (1944)

will be budgeted from current revenues for faster debt retirement than at the normal rate. In this fashion, though the budgets are still prepared and implemented annually, the perspective has shifted into the window of a full cycle, so as to better handle revenue fluctuations from the economic cycle.

This was a daring policy recommendation against the background of the dominance of the balanced budget norm in those years, especially the fact that in 1932 Franklin D. Roosevelt campaigned on a balanced budget platform and Roosevelt attacked Edgar Hoover for having not been able to balance the federal budget. It was several years before Keynes published his *General Theory of Money, Interest, and Employment*; but the stimulative fiscal policy was quickly introduced and implemented after Roosevelt won the election, to stabilize the economy. The policy instruments for this tremendous task were monetary policy and fiscal policy. In 1941, Alvin Hansen of Harvard University further expanded the idea of the Chicago economists. Hansen observed that to promote security for unemployed workers and the stability of the economy during the Great Depression, the federal government at first relied primarily on monetary policy, but the huge number of the unemployed compelled enormous expenditures. Fiscal policy, more by accident than by design, came onto the front stage, because monetary policy had shown limitations, were inadequate, and therefore must be reinforced with fiscal policy. Hansen further pointed out that this countercyclical use of fiscal policy should include a spending component as well as a tax component, both to be countercyclically adjusted and administered. Milton Friedman in his (1948) *American Economic Review* paper on economic stability proposed a framework with both monetary and fiscal policies and tools. In the framework, he called for balancing two sides, efficiency of the economy for long-run growth and short-run stability to reduce fluctuations. The evolution of theories culminated in Richard Musgrave's (1959) *Theory of Public*

Finance, where he formally expresses economic stabilization as one of the three major functions or economic justifications for modern government. Musgrave defines stabilization as key performance indicators of the macroeconomy such as high employment, price stability, sound foreign accounts, and reasonable economic growth. The stabilization role has conventionally been presumed to be reserved for the central government (Musgrave 1959; Oates 1972). It is believed that fiscal policy at the subnational level is procyclical: When a recession hits, subnational governments would reduce expenditures or increase taxes, while in boom years tax cuts and expenditure increases by these governments would be expected.

2.2 Economic Stabilization by Central Government

To well play the stabilization role following the above theory, government is supposed to implement both monetary and fiscal policies against the expansionary and contractionary phases of the economic cycle. Monetary policy is at the sole control of central government. The policy tools, like prime interest rate, reserve requirement, and discount rate, are designed to run against the cycle. There has rarely been any doubt about the countercyclical practice of these tools, because the primary goal of monetary policy is economic stability. When monetary policy is not used against the cycle, problems begin to ferment. Irving Fisher (1911) examined the 1837–1841 and 1873–1879 recessions; he found a strong link between over-borrowing during the boom and recessions that followed. A later edition of this book (1933) applied this theory of financial crisis to the 1929–1933 Great Depression and only proved it to be true. Monetary policy is not within the scope of this book; I focus on fiscal policy.

2.2.1 Fiscal Policy for Economic Stability

In contrast to monetary policy in its goal exclusivity, fiscal policy simultaneously pursues tripartite goals – to control government size (allocation), to strive for equity (distribution), and to constrain cyclical fluctuations of the economy (stabilization). Goal multiplicity in fact places stabilization often in conflict with the other two goals, leading to serious compromises in its countercyclical practice and policy outcome. Since emergence of fiscal policy in the 1930s as a countercyclical policy (Keynesianism), most central governments all over the world have in most cases been applying this policy in every recession. The basic principle behind its application is common sense that Mankind has practiced for ages: Save while harvests are bountiful for use in years of famine. In contemporary context, it is to apply the main tools of fiscal policy – taxation, public expenditure, and debt – against the boom-bust cycles of the macroeconomy: Save surplus tax revenues and retire debt during booms in order to increase public expenditure during busts. However, the cyclical orientation of fiscal policy, to be procyclical or countercyclical, was for a long time not clear; part of the reason lies in its goal multiplicity.

The working mechanisms of fiscal policy instruments are of two kinds. The first are automatic stabilizers, those that are designed into the expenditure and tax systems and do not need any policy action for them to be put to use; the policy tools are triggered by indicators of the economy. An example is the progressive marginal rates of the individual income tax: In boom years people earn more money and are subject to higher marginal tax rates (for higher income brackets); during recessions their income fall and are subject to lower marginal rates. Another example is unemployment insurance that is effective when workers are unemployed and automatically become eligible for this benefit. The second mechanism is discretionary; such fiscal policies are made for specific occasions and events. Examples include temporary tax reductions that come with a legislative action and other expenditure programs that need legislative approval.

2.2.2 Problems with Discretionary Policies

Problems often occur when fiscal policies are placed at the discretion of policymakers. Scholars have identified technical problems as three types of lags (Friedman 1948, 255–6; Blinder 2006). The first is the lag between the need for government action and recognition of the need. The lag arises because politicians need economists for analysis of the economy; economists need data to conduct the analysis whereas data are post ante, always behind the reality. On the other hand, policymaking relies heavily on forecasting, which is constantly a “failing” business: Because there always exists a lag between data and reality, results are often not reliable. The magnitude of lag depends on the discretionary policy proposal; the lag can be very long or very short. But such lags are very small or almost nonexistent for automatic stabilizers.

The second type is the lag between recognition of the need for action and taking the action, which exists even for automatic stabilizers, because financial administration takes time whether it is collecting taxes or processing and mailing transfer payments. However, appropriate construction and administration of tax and transfer systems, in particular with advanced information technology that is now readily available, can potentially reduce this lag to a negligible extent. For discretionary actions, the length of the lag depends on the action to be taken: In cases where it is necessary to change expenditure policy, the lag can be the longest; even elaborate advance planning will not be able to eliminate the lag. If the policy involves capital construction, it necessarily takes time to get projects under way without causing much efficiency loss. The third type of lag is that between the action and the policy showing designed effects, which will be present in both automatic and discretionary actions.⁴

Besides, there are political problems with discretionary policies, mostly related to the second type of lag. These problems occur due to conflict between the White

⁴ As far as I know, Friedman (1948) first identified these three types of lag. Blinder (2006) calls the first and third types “inside lags” and the second “outside lags.”

House and the Congress, especially when the executive and the legislative branches of the federal government are controlled by different political parties. These problems also occur within the Congress, shown as conflict between the majority party and the minority party. Heavy influence of interest groups and struggle between different states for federal resources also may give rise to conflicts. This is why there has been long lead time between recognition of the need for action and taking policy actions. (However, there are exceptions. Seidman (2003) cites examples of very short lags, in 1975 and 2001, when emergencies prompted quick action by both the President and the Congress.)

To be effective in stabilizing a downturn economy, the total size of the countercyclical fiscal policy, including stimulative public expenditure, debt issuance, and tax reductions, must be large in amount. Effective economic stabilization thus requires the federal and state governments to coordinate their fiscal policies. When the federal government increases expenditure, the policy outcome will be reinforced if states follow suit by increasing their own outlays to supplement federal spending; the outcome will be less effective if states simply maintain their usual spending level, without supplements to federal outlay; the worst is when states reduce their own spending. In the last scenario, the outcome of federal policy is seriously compromised. Effective stabilization also calls for government to offer fiscal incentives for businesses to increase capital investment and retain their workforce.

2.2.3 Debate on Stabilization Policy

Because of the many problems with discretionary fiscal policy discussed above, there has been heated debate among scholars about the efficacy of such policies. Despite the fact almost all central governments resort to fiscal policy during each recession, the debate has been far from being settled. Founder of countercyclical fiscal policy J. M. Keynes and the forerunner of this policy in the USA Paul Samuelson both emphasized the multiplier effect of government expenditure in downturns; but later empirical studies found the multiplier effect is “transitory.” Alan Blinder admits that “[t]he macro economy has the natural-rate property”; “output returns to potential”; and “[t]he path of potential output is unaffected by either monetary or fiscal policy” (2006, 28). Indeed many causes can be identified that lead to variation in revenue flows (Stonecash 1994), including actions of politicians, new taxes, and raising and cutting existing taxes; changes in the economy and recession are just part of the basket of potential reasons. Therefore, despite the long-standing support among Keynesian economists for economic stabilization, other economists cast a skeptical eye about the utility of stabilization policy.

Gregory Mankiw (1992) summarizes the opposing views in three connected points. First, the best option is probably a passive policy instead of an active one. Second, if the consensus is to do something, then the optimal route is to be committed to some pre-set, fixed policy rule rather than granting policymakers’ discretion over monetary and fiscal policy. Indeed theoretical and empirical research by Finn

Kydland and Edward Prescott (1977) and John Taylor (1982) reveal substantive advantage of rules over discretion. Third, even if we can stabilize the economy with ideally designed and implemented policy sets, the benefits would not be large if we believe in the natural rate hypothesis, by which the actions of stabilization policy merely level off the intensity of cyclical fluctuations around the natural rate but do not change the average level of output and employment. By the real business cycle theory, cyclical fluctuations are the “optimal response of the economy to changing technology”; therefore “policymakers should not stabilize the economy, even if it were possible” (Mankiw 1992, 486).

A direct answer to such doubts is straightforward: Drastic fluctuations in the budgets of state governments have in history caused and will again and again cause huge interruption to public life. Revenue shortfalls due from economic cycles have repeatedly shown that the subnational sector is prey to economic fluctuations. Public expenditures should not be a subject to cyclical fluctuations as private investment is.⁵ Stabilization of state budgets is therefore a big public good, which is worth the effort. As shown in subsection 2.1.2, for decades scholars and practitioners have been calling for countercyclical fiscal policy. The tide has been rising with recessions and ebbing with expansions – the lesson is still not thoroughly learned.

Regardless of the academic debate among economists, demand is high during every recession for government to take stabilization actions. It would be politically incorrect and ethically unacceptable if government does not do something to at least temporarily ameliorate the sufferings of the unemployed during the depth of recessions. The fact that central governments worldwide launched stimulus packages to mitigate the Great Recession helps reconfirm that fiscal policy faces a practical, worldly expectation, if not pressure, to be applied against the economic cycle. The damage of no action would be devastating to productivity and the unemployed.

2.3 Stabilization at Subnational Level

The procyclical fiscal behavior of the states has long been noticed, as Hansen (1941) pointed out about the procyclicality of state fiscal actions during the Great Depression (see Table 2.1). Local governments are even more procyclical. Rafuse (1965), the Advisory Commission on Intergovernmental Relations (ACIR 1978), and Fisher (1984) found further evidence of the cyclical patterns of the state-local sector from 1957 to 1977 and from 1978 to 1984, respectively, by examining the quarterly change rates of revenue, expenditure, and budget surpluses. Their findings are summarized in Table 2.2, which shows budget surplus of the state-local sector was a direct function of the economy: Surpluses accumulate during expansions and disappear during contractions. Such patterns of procyclical fiscal behavioral, however, are not surprising given their operating environment: States (and localities) operate

⁵ Musgrave 1978, 31.

Table 2.2 State-local fiscal behavior 1957 III to 1982 IV

Peak	Trough	Receipts growth (%)	Expenditure growth (%)	Surplus change (billion \$)
Panel A: Behavior during recessions				
1957 III	1958 I	1.7	2.9	-0.55
1960 I	1960 IV	1.9	2.1	-0.10
1969 III	1970 IV	2.8	3.2	-0.46
1973 IV	1975 I	2.6	3.3	-1.32
1980 I	1980 II	0.5	1.9	-4.70
1981 III	1982 IV	1.3	1.8	-1.66
Panel B: Behavior during expansions				
1960 I	1958 I	2.4	1.5	0.34
1969 III	1960 IV	2.5	2.4	0.08
1973 IV	1970 IV	2.9	2.5	0.80
1980 I	1975 I	2.5	2.1	6.15
1981 III	1980 II	1.8	1.3	3.06
1984 IV	1982 IV	2.1	1.8	4.95

Data source: 1957–1977 data, ACIR 1979, Report A-70; 1978–1984 data, Fisher 1984, 107

under legally binding balanced budget requirements, (now) face revenue and expenditure limitations, and are restrained by statutory debt limits.

2.3.1 *Stabilization Theory Extended to Subnational Level*

In the mid-1940s, after countercyclical fiscal policy (CCFP) had taken shape and been implemented by the federal government to take the country out of the Great Depression, Alvin Hansen and Harvey Perloff (1944) extended the argument for such a policy orientation to the subnational level, the state governments in the United States. They suggested that a rational countercyclical fiscal policy was urgently needed not only at the federal level but also at all levels, and the policies at national and subnational levels should be coordinated (41). In this groundbreaking book, Hansen and Perloff offer details of their “rational” or ideal countercyclical fiscal policy on tax rates, level of public expenditure, borrowing and debt: In years of recession, tax rates should be reduced, and public expenditure should be high by drawing on accumulated reserves and incurring public debt. Fiscal policy in general shall be directed toward increasing consumer purchasing power and stimulating investment and business activity. For this purpose, tax rates during economic booms should be high in order to drain off excess consumer purchasing power and to accumulate reserves for revenue shortfalls in the future; public expenditure in contrast should be kept low, at a level just adequate to maintain essential social services. Borrowing for further expansion in such periods should be eliminated, and accelerated repayment of public debt should be pursued if the boom is strong (48–49).

Intuitively the countercyclical features of such a fiscal policy make sense, but in practice they are difficult to implement in the real world of popular voting and budgetary politics, especially during economic prosperity. Major obstacles may come from three sides. To begin with, states are limited by their constitutions or statutes from accumulating high levels of surpluses. Even in the absence of legal restraints, individual and corporate taxpayers tend to exert spending pressure on elected officials during booms to expand public expenditures and/or reduce tax rates; and elected officials either share the general optimism or simply follow the voters' will to facilitate their own reelections (even if these elected officials may understand the validity of the rational fiscal policy). Finally, the goals of economic development lead to inter-state competition for businesses (investment) which induces, or even dictates, reduction of tax rates. Thus, in the federalist framework of the United States a subnational government can resort to one or more of the following three means in a recession to implement against-the-cycle fiscal policy, each with its pros and cons. First, since the federal government has monetary policy and controls more and wider taxing power, federal grants are a valuable financial source. However, obtaining such grants is often unreliable. As experience goes, federal grants may not come as early or at the amount states may need and expect. Besides, where a grant is based on a matching ratio, poor states are hit hard. When a state is in fiscal distress, it often has to cut its assistance to local governments.

The capital market is another means of addressing recession pressures, since increasing public debt for capital projects in downturns is technically sound. However, recession years are the time when states often have to adopt drastic fiscal measures which adversely affect their credit rating and thus erode their borrowing capacity on the market. Besides, strict debt limitations as prescribed in state constitutions or statutes do not grant states indefinite room for incurring debts. Then, the only means that is consistently reliable, independent of outside control is own-source reserves. The availability of reserves depends on two internal factors. First, the legal framework – statutory balanced budget requirements on a (bi)annual basis offer little room for flexibility in this context. Second is the human factor – chief elected officials must possess not only the managerial foresight for the necessity of reserves but also the political courage and skills to resist and manipulate spending pressures during prosperity. Once accumulated, reserves must be guarded against any possible raids in boom years. The best means for counteracting these two internal factors is an institutionalized device that provides statutory protection of the reserves.

The July 1949 “Budget Theory Symposium” held at Princeton, New Jersey, dealt with the legal framework. Conferees to the Public Administration Clearing House (PACH) succinctly pointed out that “there is no magic” about the 1-year period of the annual budget; that the most important issue is “stabilization of tax expectance [for businesses]”; and that “longer projections and more frequent reviews by the legislative body are both desirable....⁶” This statement partially

⁶Symposium on budget theory. *Public Administration Review*, 1950, 1(10), 20–31.

softens the theoretical foundation of the annual budget. The theory, however, stayed at a stalemate. Musgrave (1959) cautioned that the stabilization function is to be played exclusively by the central government because lower levels do not fit: Subnational governments do not have monetary policy; their revenue sources are limited and taxes cannot be structured progressively; further, capital and labor as factors of production are fully mobile.

Explorations kept going. Rafuse (1965) checked the patterns of change in state and local annual surpluses in the form of general fund balance from the 1930s to the late 1950s; he found these surpluses followed a cyclical pattern of accumulating in boom years and declining in bust years and became “more and more stabilizing with each succeeding [business] cycle” (118). A report by the United States Advisory Commission on Intergovernmental Relations (ACIR) confirms this policy change: “...during each economic downswing since World War II, state and local fiscal behavior was ‘correct’ [meaning ‘counter-cyclical’] because [spending more from reserves] added to aggregate demand [during downturns]” (1978, 6). Bahl (1984) also provides evidence that US state and local governments do implement some practices that go against the economic cycle: They put aside some balances in their general fund even under the balanced budget requirement and spend these reserves once a recession hits.

Another round of systematic theoretical exploration came in 1987 when Edward Gramlich published his seminal paper on the subject. Citing macroeconomic evidence, Gramlich argues that (a) “demand shifts in the whole country are not highly correlated; (b) labor may not be highly mobile; (c) regional import and export propensities may not be as high as was previously assumed; (d) domestic debt of the national government is no longer different from external debt of subnational governments; (e) the open economy critique and inter-generational critique against stabilizing fiscal policy at the national level seems less relevant at subnational levels;” and (f) “states have persistent business cycles independent of the national cycle” (Gramlich 1987 3–27). Therefore, Gramlich concludes that the conventional wisdom in this regard may have been inaccurate – states should not only pursue countercyclical fiscal policies but have in fact adopted such practices to stabilize their budgets, and that we can reasonably assume that subnational fiscal policy can exert at least short-term influence.

Analyzing the cyclical response of state budgets over the economic cycle, Gramlich (1991) distinguishes three types of state fiscal policies: neutral, perverse, and stable. The first type discourages subnational governments from conducting the countercyclical policy, and advocates automatic fluctuation of taxes and budget surpluses with changes in income. The term “neutral” implies no countercyclical action and no changes to the tax structures over the economic cycle, so revenues move procyclically; but state expenditures grow at a constant rate through the economic cycle. The budget would balance over the whole cycle but not year by year. If following a perverse-type policy, governments would initiate discretionary tax increases and/or expenditure reductions during recessions, and cut taxes and increase spending in boom years. This is perverse policy – balancing the budget year by year amplifies the fluctuation from the economic cycle. This tripartite theory traces back to Hansen and Perloff’s (1944) book but carries its own merit. Gramlich advocates

a fiscal policy for stability: Subnational governments should try to smooth the economic cycle by using countercyclical fiscal policy – raising taxes and/or cutting spending during expansion to accumulate reserves, then lowering taxes and/or increasing spending during recession by releasing (decumulating) reserves. The latter part resembles the so-called active fiscal policy at the national level. Such a policy aims at accumulating more reserves in booms so as to be able to release more during a recession than the neutrality policy can afford. The budget would then be balanced over the economic cycle. What Gramlich means here by balancing the budget is total revenues equal total expenditures over the economic cycle. This is different from the statutory balanced budget requirements (BBR) in the states. BBR focuses on deficit prevention but leaves open the option for states to run surpluses, which is the practice adopted by many states. This remained true even after the tax revolt movements in the late 1970s and early 1980s.

Gramlich's proposal was an intensive version of subnational countercyclical fiscal policy, involving accumulating reserves and tax rate changes. No states have adopted this version of the policy. The reason is easy to see. While saving reserves in one way or another is common, tax rate changes, especially permanent ones, are much more difficult and thereby less common because tax increases are politically unpopular. A weaker version of his proposal with only countercyclical reserves but no tax rate changes is what many states have practiced.

2.3.2 *Stabilization Practices by State Governments*

In the real world of government administration, New York was the first state to respond, in 1946, to the previous theoretical progress that culminated in the 1944 Hansen and Perloff proposal. This was the first “budget stabilization fund” (BSF) at the state level – the New York State “Tax Stabilization Reserve Fund.” The purpose of the fund was for stabilizing own-source “revenues of the state from taxes, fees and other sources required by law,” with the funding source being annual fiscal-year end cash surpluses.⁷ In the official language of the state, the fund was “a safeguard against possible future declines in revenues.”⁸

The concept and adoption of the budget stabilization fund spread very slowly. In 1959 Florida legislated its “working capital fund” to “avoid deficits due to minor fluctuations in revenue or spending,” with savings from annual excess resources.⁹ Another 13 years passed before Tennessee adopted its “reserve for revenue

⁷ For details, see *New York State Consolidated Laws, Chapter 56: State Finance Law, Article VI: Funds of the State*. New York State, Albany, NY; Section 92.

⁸ *Annual Report of the Comptroller for the Fiscal Year Ending March 31, 1946*. State of New York, Albany, NY, 1946; 5.

⁹ For details, see *Florida Statutes, Title XIV: Taxation and Finance, Chapter 215: Financial Matters: General Provisions*. State of Florida: Tallahassee, FL.; Section 215.32.

fluctuations” to “meet unexpected shortfalls of revenue or expenditure requirements in excess of budgeted appropriation levels,” with monies from annual general fund appropriations.¹⁰ In another 4 years, California and Georgia followed suit by establishing their own BSFs. These first state BSFs were designed following a weaker version of the Hansen and Perloff model, that is, to save the annual surpluses in prosperity but not to raise tax rates in boom and then temporarily lower the rates in a recession. In fact, it has been almost universal that state BSFs are weaker versions of the proposals by theorists.

As a state with a large share of the manufacturing industries, Michigan’s economy and government finances suffered huge fluctuations in the 1974–1975 and earlier recessions. The severe economic and budgetary difficulties forced the state to seek a permanent solution. Such efforts led to the creation in 1977 of the Michigan “countercyclical budget and economic stabilization fund,¹¹” which, in comparison with its earlier counterparts in other states, has two new features. First, it places an economic element in the purpose of the fund – to assist in stabilizing not only governmental revenue during periods of recession but also employment when the rate of unemployment is high. Second, the source and use approval of the fund are by a pre-set formula – the percentage above the 2% annual growth rate benchmark determines the amount to transfer into the fund in the next fiscal year, and the percentage of negative annual growth rate determines the amount to be used from the fund in the current fiscal year. The Michigan legislation became a model for many other states. It was “copied” in Ohio, Indiana, and Washington, and it influenced the BSF legislation in many more states. It is not an exaggeration to say that widespread adoption of BSFs among the states started with the 1977 Michigan model legislation accompanied by other social economic factors. Though these first BSFs were lonely swans among the 50 states, the practice of countercyclical fiscal policy had spread out through a wise use of general fund surpluses accumulated from boom years; thus, the perverse policies of the 1930s were gradually evolving into the more rational fiscal policies since World War II.

2.3.3 *Summary: Budget Stabilization*

Thus, we can conclude that even though debates among economic theorists have not achieved consensus on the efficacy or ultimate utility of macroeconomic stabilization, governments do need to make strong and committed efforts in order to stabilize government budget, that is, to smooth public service provision across the economic cycle, because this is the demand from the society, individuals, households as well

¹⁰ For details, see *Tennessee Code Annotated*. State of Tennessee: Nashville, TN; 9-4-211.

¹¹ For details, see *Act 76 of 1977 (repealed)*, and *Act 431 of 1984*; also *Michigan Compiled Laws, Chapter 18: Department of Management and Budget*. State of Michigan: Lansing, MI; Section 351–359.

as businesses. Therefore, countercyclical fiscal policy are demanded, justified, and has been shown as useful. In a more realistic sense, the stabilization function is best interpreted as macroeconomic stabilization for central governments; at the subnational level it is budget stabilization for smoother public services through the economic cycle.

However, a rational policy and proper policy tools are not a panacea to cure all ills from governmental revenue shortfalls. The countercyclical policy and relevant tools are but the means, which must go through the human hands of implementation to be effective, that in turn lies ultimately in the domain of politics. Specifically, a wise fiscal policy may be brushed aside; appropriate policy instruments can run distorted; and fiscal reserves that are adequate by the most sophisticated formula might as well be used off the right target. Therefore, the solution returns to the very basics of fiscal restraint and budgetary discipline. It would be a misconception that a rational policy can solve the problem once and for all.

Countercyclical fiscal policy among the states, as with many other practices that were initiated at the subnational level and later transplanted into the federal government, has drawn the attention of the federal government. Although the federal government with monetary policy in its hands does not need a distinct budget stabilization fund,¹² the General Accounting Office (GAO) in a special report to the United States Senate Committee on the Budget recommends that “should the Congress decide to move to a reserve-funding model for emergencies, state practices [to provide a cushion for budget uncertainty] provide some insight in designing such a process.¹³” In history the federal government played some role in providing countercyclical fiscal help to the states; whether that should be resumed in the future may also come onto the agenda of the national leaders at some time.

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¹² *States' Use of Surplus Funds*. Congressional Budget Office: Washington, D.C., November 1998.

¹³ *Budgeting for Emergencies – State Practices and Federal Implications*. GAO/AIMD 99–250. The United States General Accounting Office: Washington, D.C., 1999; 1–4.

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