Introduction

Economic and Fiscal Performance in a Mean-Variance Perspective

American states ended the twentieth century on a winning streak. Most had participated in an uninterrupted eight-year economic expansion that lifted living standards to record levels and reduced unemployment rates to thirty-five-year lows. This string of favorable economic events, coupled with a progressive tax structure, caused a surge in state government coffers. State legislators and governors wrestled over what to do with this flood of new revenues, relishing the choice between cutting taxes and expanding their favorite projects. The forces favoring new spending basically won that contest. The typical state budget in the 1990s outpaced state income growth by nearly 1 percentage point annually. At the same time, federal government spending declined as a share of national income, effectively shifting power from Washington to the states.

Those were heady days in the state capitals. Thousands of state politicians had never shared responsibility for a revenue shortfall. Fewer than half of elected state lawmakers had held office long enough to experience hard fiscal times.

The economic winning streak ended early in the new millennium, and the fiscal tide began to turn. In 2001 many state economies began to sputter even before the terrorists attacked the World Trade Center and the Pentagon and new risks to homeland security became a reality. In that year, 44 states reported revenue collections that were below expectations, requiring unpleasant choices not confronted for a decade: spending cuts, tax increases, increasing debt, and dips into rainy-day funds.

Looking back at the 1970–99 period, one finds recurring episodes of major economic stress that squeezed state revenues: 1990–91, 1982, and 1975. Even in these earlier periods of national recession, we discover vast differences in how the individual states fared, how each reacted to changing economic circumstances, and how their economies and budgets bounded and rebounded. As a general matter, few states mirror the "national" economy. Yet the notion of a "U.S. economy" routinely dominates the way we encapsulate, aggregate, and characterize economic conditions that are actually quite unalike at the state level.

In the final three decades of the twentieth century, living standards in the United States increased by 50 percent, or by about $11,500 per person (in 2000 dollars). In North Carolina, the state growth champion, real income rose by nearly $13,000 per person, a 64 percent rise. In Alaska, the state laggard, income grew by 28 percent, less than half the rate in North Carolina. Of course, one might write off Alaska's poor showing to the vicissitudes of oil prices. But what about California's relatively anemic 37 percent growth or Ohio's below-average 42 percent growth? Economic performance in these and other states paled in comparison to the 60 percent plus real growth in states such as Colorado, Massachusetts, and Virginia.

Why do the American state economies grow at such vastly different rates and manifest wide differences in living standards? This question rightfully occupies a prominent place in the history of economic analysis. Few issues in social science are more worthwhile than the sources of rising living standards. This study joins the discourse by examining the economic and fiscal history of the American states in the last three decades of the twentieth century. It dives deeply into these historical data in search of new insights about the factors that stand behind state economic success.

The Role of Volatility in State Economies and Fiscal Policy

The central point of departure is the elevated role of volatility. This departure from traditional analyses of economic performance tracks the perspective in modern financial theory that emphasizes a two-dimensional, or mean-variance, criterion for evaluating portfolios. Just as rates of return alone provide an incomplete basis for gauging portfolio performance, the level or growth in state economies reveals an incomplete and perhaps distorted picture of performance. Taking the volatility of state economies explicitly into account refines the whole notion of "economic success."

This book explores and illustrates the considerable promise of a two-dimensional or mean-variance criterion for assessing state economic performance. For example, the empirical analysis finds that high-income states tend to be significantly more volatile than low-income states, which raises a host of doubts about the adequacy of traditional models of economic development. Some citizens may simply prefer a low volatility to a high volatility environment, even though this choice requires some sacrifice in the form of residing in a state with below-average income. The mean-variance perspective amends applications of growth models that rely on the mobility of productive factors keyed to income levels alone. The elevated importance of state economic volatility also ushers in novel questions about the determinants of volatility and the interplay between the volatility and the level of state income.

In addition to economic volatility, the book explores and accents the importance of the volatility dimension in state fiscal policy. For example, the analysis of state revenues considers the reliability of alternative tax instruments by computing and comparing the volatility in revenue flows from specific tax sources. Regarding expenditures, the analysis discovers a systematic trade-off between the volatility of state budgets and the efficiency of public sector operations.

Overview of Chapters

The book is organized into 10 chapters. Chapter 1 begins with a review of state economic performance, detailing the variation in living standards and economic growth rates among states. Chapter 2 investigates the pat explanation for the state growth process from neoclassical economics, the "convergence" thesis, which posits that low-income regions will outperform and therefore catch up with the living standards in high-income regions. The appealing simplicity of the neoclassical convergence thesis fails to explain the state experience for at least 25 years; income convergence among the American states ended in the mid-1970s.

Chapter 3 introduces the mean-variance perspective as a positive framework for analyzing state economic performance. Two techniques for computing state economic volatility are developed, and these measures are used to rank and exposit the extent of volatility among states. The chapter surveys alternative theories for an underlying relationship between the level and volatility of state income and probes this relationship empirically. As previewed in the preceding discussion, the statistical models reveal a significant and positive correlation between income and volatility, consistent with the risk-return relationship observed in standard portfolio analysis.

Chapter 4 moves the analysis into the realm of state fiscal policy, specifically beginning with an overview of the evolution of state tax structures. States relied on sales taxes as the predominant revenue source in the 1960s but steadily replaced it with the individual income tax in the succeeding three decades. By the late 1990s, collections from the state income tax were nearly on a par with collections from the sales tax in the typical state. Chapter 5 and chapter 6 proceed to related issues: the progressivity of state tax structures, the impact of income versus sales taxes on economic performance, and the reliability of these alternative revenue sources. The analysis of revenue reliability again brings the role of volatility to the front burner. The results from these analyses help to explain the demise of the state sales tax and its replacement by the income tax. The state sales tax deters economic performance and, contrary to conventional wisdom, provides a less reliable revenue source than the state income tax in almost two-thirds of the states that levy both types of taxes.

Chapter 7 takes up the spending side of fiscal policy, highlighting the wide variation among states over the 1970 through 2000 period. Chapter 8 returns to the mean-variance perspective, in this case applying it to state budget processes. The analysis demonstrates that uncertainty is the enemy of efficiency in public as well as private enterprise. If public budgets are volatile and therefore difficult to predict, agencies incur higher operating costs than if budgets are stable and predictable. State fiscal volatility creates uncertainty that limits the efficiency of agency planning and thereby tends to increase state spending. In light of the elevated importance of fiscal volatility, chapter 8 examines the role of fiscal institutions in a mean-variance perspective. Institutions such as balanced budget requirements, tax and expenditure limitations, biennial budgeting, and the item veto affect fiscal volatility and through this channel have indirect as well as direct effects on the size of government. In essence, fiscal institutions take on a more subtle and significant role in state budgetary processes than previous analyses have appreciated.

Chapter 9 examines the composition of state budgets and the relative influence of various forces in determining spending priorities. The influence of political ideology matters, but not nearly as much as fiscal volatility and fiscal institutions. Chapter 10 reiterates the major results and summarizes the lessons in state political economy that emerge from the study.