

*State Government Response to Income Fluctuations: Consumption, Insurance, and Capital Expenses*

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This paper analyzes state government response to changes in the underlying economy. The consumption smoothing literature has generally examined how state government current expenditures respond to changes in tax resources. Our paper recognizes explicitly that state governments are agents of the residents, responsible only for the collective part of the consumption bundle. Further, state governments additionally serve as an income insurance agent for residents, through not only unemployment insurance but through low income assistance programs as well. Thus we use panel data on states to separately examine how state governments alter their consumption expenditures in response to residential income variation, which is expected to be quite different from how states alter “insurance” payments. Finally, we compare these changes in current expenditures to changes in capital expenditures. The adjustment pattern of capital expenditures is likely to be quite different due not only to institutional features that make smoothing easier, but because price movements may change the cost-benefit analysis.