The interjection of the volatility dimension breathes new life into well-plowed fields of political economy. Start with the extensive diversity in living standards among the American states, diversity that increased even further in the closing decades of the twentieth century. This pattern of income divergence defies the convergence pattern anticipated by neoclassical growth theory. The mean-variance perspective finds fertile soil in this crevice between fact and theory. States not only differ widely with respect to living standards and growth, but they differ widely with respect to the volatility of their economies. The metrics constructed to assess and compare state economic volatility provide the means to unearth a new and fundamental relationship. State income and state volatility are positively correlated, analogous to the fundamental risk-return trade-off at the heart of modern portfolio theory.

High volatility tempers the attractiveness of high-income states to potential workers and investors, which implies that income differentials may persist when factor location decisions take into account these dual criteria. In the neoclassical framework, differentials among states in expected incomes and rates of return alone drive factor mobility. But that analysis overlooks an essential element of the market adjustment process. A stable state economy substitutes for a hike in income for the same reason that some investors prefer a low-risk, low-return portfolio to a high-risk, high-return portfolio. Put differently, higher than average state incomes appear to reflect in part a risk premium. Furthermore, low-income states experience commensurately low levels of economic volatility, a finding that confounds a simple judgment about state economic conditions. Risk-sensitive residents could reasonably judge state stability as an attribute of a successful economy. The mean-variance perspective at once helps to explain state economic diversity and makes more difficult the appraisal of state economic performance.

In the domain of fiscal policy, the focus on volatility exposes new
ground. Consider the analysis of revenue volatility. Conventional theory and practice embraces the view that sales taxes generate a highly reliable revenue stream. This thesis holds that household consumption patterns vary less over time than household income and that this consumption-smoothing effect carries over to the revenues derived from these alternative tax bases. Yet, the appropriate measures of revenue reliability indicate otherwise. In almost two-thirds of the states that levy both individual income taxes and sales taxes, revenues from the sales tax are more volatile than revenues from the income tax. The conventional wisdom that the sales tax provides a relatively reliable revenue stream has no factual basis in the American states.

Similarly confounding conventional wisdom, the evidence strongly indicates that state economic performance is more sensitive to marginal rates in the sales tax than it is to marginal rates in the individual income tax. A number of prior studies have investigated the impact of taxes on state economic performance, but none has isolated and evaluated the separate effects of sales versus income taxes.

The evidence that sales taxes imperil state economic performance offers a plausible explanation for the growing aversion by most states to a heavy dependence on the sales tax. In the 1960s sales taxes were the predominant tax revenue source for American state governments, accounting for nearly 80 percent of tax revenues in the median state. By the end of the twentieth century sales taxes were roughly on a par with income taxes in the typical state. As the empirical findings subsequently indicate, volatile tax revenues beget spending volatility that fuels budget increases that, in turn, require additional revenue. Given that sales taxes offer little in the way of volatility relief and that they deter economic growth, state policymakers have clear incentives to steer away from this tax instrument.

The observations and analyses regarding state taxes convey a broad lesson of considerable importance. What might be sound tax policy for a large, national economy (the use of consumption taxes) does not translate into good policy for a small, open economy such as an American state. The theory that a consumption (sales) tax encourages savings and therefore growth-promoting investments makes little sense at the state level. The reason is twofold. First, even if a state’s sales tax restrains consumption expenditures, the increased pool of savings flows readily across state lines. That is, any expansion in investment activity from the sales tax–induced savings can hardly be expected to remain within the borders of the state that levied the tax. Other states and nations reap the investment benefits from one state’s tax inducement to
save. Second, consumers residing in high-tax states make at least some of their purchases from vendors located in low- and no-tax states. Legally, a consumer who makes an out-of-state purchase is required to remit the applicable sales tax to his or her state of residence, but compliance with this essentially self-policed rule is minimal. Looking ahead, the adverse growth consequences of the sales tax exposed by analysis of late-twentieth-century data will be magnified greatly in an economy immersed in electronic transactions. The ubiquity of the Internet as a vehicle for electronic commerce undoubtedly will fuel an explosion in out-of-state purchases in the twenty-first century. For this reason we can anticipate an acceleration in the documented demise of the state sales tax.

The splurge in American state government spending in the final three decades of the twentieth century was perhaps overshadowed by concerns about the exploding national debt. Yet, in 1998 the size of the federal government as a proportion of national income sank below its level in 1969. Meanwhile, state government spending as a share of income continued to rise at an annual clip of about 1 percent in the typical state. Here again diversity is the rule, and the convergence thesis explains little about the pattern of spending among states.

The mean-variance perspective applied to state budget processes provides at least a partial explanation for state spending patterns. The historical analysis of state spending reveals that budget volatility is positively correlated with spending. This raises the important theme that fiscal uncertainty is the enemy of government efficiency. Within this context, the impact of state fiscal institutions takes on new relevance. 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 effects as well as direct effects on the size of government. The results of this analysis indicate that fiscal institutions play a more subtle and significant role in the state budgetary process than traditional analyses have appreciated.

The material role of fiscal volatility offers constructive suggestions for state policymakers. For instance, implementing procedures that promote budget stability significantly improves agency planning and efficiency, and such changes can improve state services without additional expenditures. In addition to the biennial budget process that was explicitly examined, other procedures such as funding programs via multiyear block grants would appear to offer comparable benefits.
In general, institutions that reduce the uncertainty in government agency planning yield potentially large gains in efficiency.

This study began with a familiar question: why do the American state economies grow at such vastly different rates and manifest wide differences in living standards? The elevated importance of economic and fiscal volatility offers new policy-relevant insights and ideas that map a course for future research.