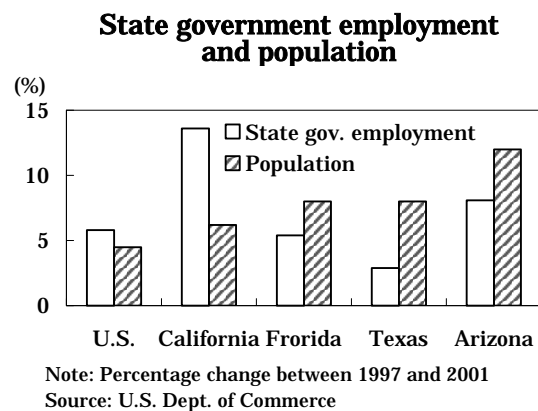
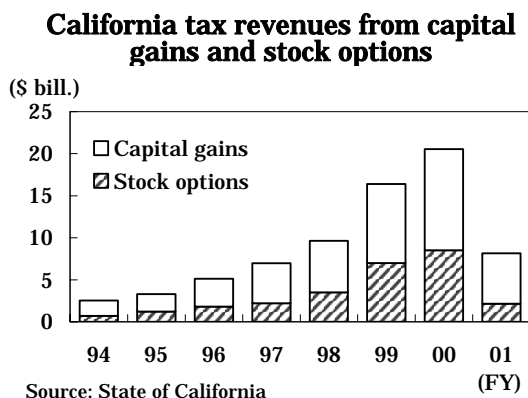


The crisis in U.S. state finance: its factors and risks in the future¹

There is growing concern that large deficits in state finance may become another drag on the U.S. economy, as rebalancing budgets by states could entail deflationary impacts.

In most states, except Vermont, budgets must be balanced by law, but recession periods are exceptions. As the economy has slowed and stock prices have fallen, the sum of state budget deficits has widened from \$24.5 billion as 0.2% of GDP in fiscal 2001 (July 2000 to June 2001) to \$45.9 billion as 0.4% of GDP in fiscal 2002 (July 2001 to June 2002).

The most notable and pressing example is California, which accounts for about 12% of total population and 14% of total GDP in the U.S. As its industrial structure is skewed towards the Information Technology (IT) related manufacturing and service sectors, both state revenues and spending increased substantially during the IT bubble. Tax revenues increased substantially, as income from capital gains and stock options surged, owing to the IT bubble, while spending expanded, as state employment grew rapidly. When the bubble burst in 2000, state revenues plunged, but spending did not decline accordingly. As a result, California's budget deficit ballooned to \$6.1 billion as of November 2002, and the rating for California state bonds was lowered from double A minus to single A. In order to improve its budget balance, California plans to cut spending substantially and raise taxes, which will inevitably result in a deflationary impact on its already battered economy.



¹ This is an English summary of a report originally published on April 2, 2003. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.

The financial conditions of other states are not as serious as California, but similar problems exist. It is, thus, likely that many states will begin to cut spending and personnel, as stock prices are falling. According to our estimates, if the Dow average continues to rise during the next three years (Case 1), and state governments manage to balance their budgets in fiscal 2004, a 0.9% cut in state spending will be required, resulting in 0.3% points cut of the real GDP in 2003. But, if the Dow average remains flat at \$8,000 (Case 2), and state budgets cannot be balanced before fiscal 2005, budget rebalancing measures will cut real GDP by 0.7% points in 2003 and 0.3% points in 2004. If we assume that the Dow continues to slide and budget deficits linger during the next three years (Case 3), spending cuts between 3.3% and 4.0% will be required in each fiscal year, slashing real GDP by 1.2% points in 2003 and 1.5% points in 2005 (See table on page 3).

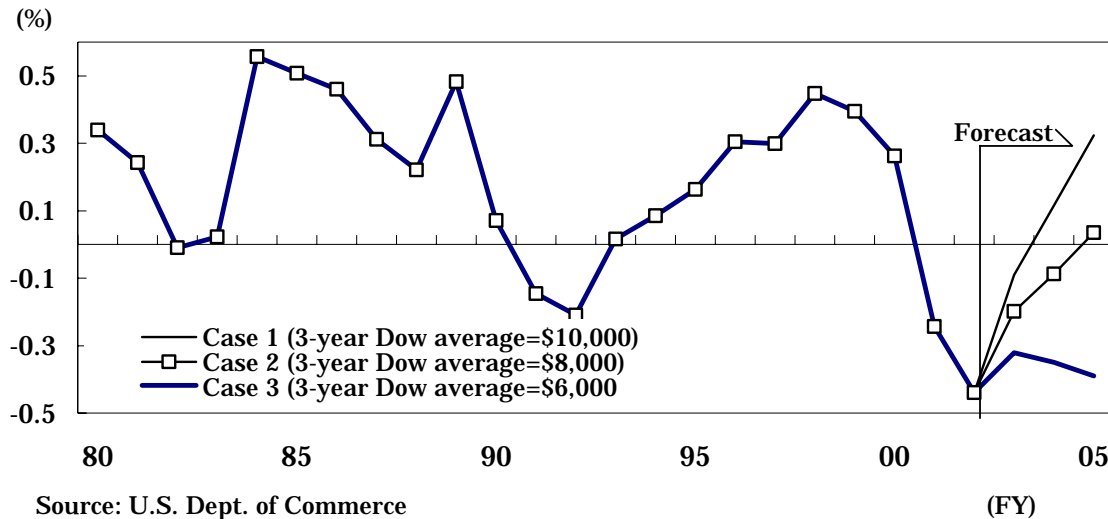
In order to balance their budgets, it is likely that state governments will cut employment, causing dampening effects on private consumption and the GDP growth rate. If spending on education is reduced, the potential growth rate of the U.S. economy may be affected in the long term. Even if budget balances turn surplus, a deterioration in the quality of public services and the decay of infrastructure, such as roads and bridges, may cause people to question the authority and effectiveness of state government. Growing deficits in state budgets may become a threat not only to the U.S. economy but also in the political balance of power.

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*The information and the views contained herein are subject to change without notice.

Estimates of deflationary impacts of budget rebalancing

1. State budget balance in terms of nominal GDP



2. Impacts on spending, employment, and real GDP

assumption		2003	2004	2005
Case 1	budget balance as of GDP	-0.1	0.1	0.3
Stock prices rise. 3-year average of Dow is \$10,000	spending growth %	-0.9	1.2	3.5
	employment growth %	-0.3	0.3	1.0
	real GDP %	-0.3	0.4	1.3
	Case 2	budget balance as of GDP	-0.2	-0.1
Stock prices remain flat. 3-year average of Dow is \$8,000	spending growth %	-2.1	-0.9	0.4
	employment growth %	-0.6	-0.3	0.1
	real GDP %	-0.7	-0.3	0.1
	Case 3	budget balance as of GDP	-0.3	-0.3
Stock prices fall. 3-year average of Dow is \$6,000	spending growth %	-3.3	-3.6	-4.0
	employment growth %	-0.9	-1.0	-1.1
	real GDP %	-1.2	-1.3	-1.5

Note: 1. Budget balance, spending growth, employment growth are figures at state level.

2. Impacts on real GDP are calculated with the following results of our estimates:

- a) A 1% decrease in state spending will reduce state employment by 0.28%.
- b) A 1% decrease in state employment will cut real GDP by 1.3%.

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