world's most productive workforce. Today, most of the U.S. economy is a "post-industrial" scrap heap, the result of 30 years of systematic dismantling and "downsizing" of her in-depth industrial and infrastructural base, and "dumbing-down" of her population. When Franklin Roosevelt came into office, there were vast idle capacities and qualified manpower that could be set into motion, practically instantly, to bring about a recovery. Today, the internal resources for recovery are relatively much less.

On this background, we need not wait for commodity prices to go up, in order to qualify Greenspan's monetary expansion as "hyperinflationary." There is literally *nothing* to back up the value of the trillions of dollars which the Federal Reserve System has created from nothing over the last half-decade—not to speak of the tens of trillions of speculative paper and debt which have been piled up on that monetary base—no real economic growth, not even the *promise* of some future generation of wealth, but only the prospect of further destruction of an already devastated physical economy. What is the worth of a currency, which is based on a bankrupt system and even worse policies? When the moment of truth arrives, it won't help much to point out, that most of the world's other currencies are in the same shape.

How 'Deflation' Feeds A Debt Bubble

Meanwhile, don't forget the crucial factor of debt. While "deflation" has wiped away trillions of dollars of fictitious financial assets, the cancerous mountain of debt has continued to grow unabated. As I emphasized in my October 2000 study, the ballooning direct and indirect costs of that debt exert a growing inflationary pressure on the economy, which has only been "compensated" by a wholesale looting of producers and workforce, outside and inside the country. Thus, nominal consumer price inflation in the United States (and industrialized nations generally) has been kept low by artificially depressing producer prices for farmers, raw material suppliers, and the Third World exporters of "outsourced" products. The difference—accruing to "middle men" and trading companies, etc.—goes into financial flows to speculation and servicing of the debt. In this process, "overproduction" serves as the pretext for ever more brutal cost-cutting. Thus, it is possible for deflationary and inflationary processes to coexist and even feed each other.

It is notable, that at the same time as commodity prices in the United States tend downward, the cost of medical and many other services, and of housing, continue to rise rapidly. These latter reflect, in my view, the gigantic inflationary pressures generated by the debt pyramid and the accelerated monetary expansion.

By the end of the 1923 hyperinflation, the total nominal national debt of Weimar Germany was worth the equivalent of a few pennies or less. Apparently, this sort of "final solution" to the debt problem is becoming more and more attractive to the loonies who run much of the world's financial system today.

State Budgets On Fire: Don't Worry, Say Experts

by Mary Jane Freeman

"Our houses are on fire!" cry U.S. state officials. "Don't worry," reply the economists, "We predict it will rain soon." That exchange summarizes recent babble, to the effect that there will be an economic turnaround by Spring, and so no need to worry about the billion-dollar revenue holes burning through state budgets. Already at the end of October, California, Florida, Michigan, New Jersey, New York, Ohio, Washington, and Wisconsin announced revenue shortfalls in the multi-billions, and many more have holes bigger than $500 million. A California headline, "State Revenue Decline Worst Since World War II," captures the reality. The high-flying revenues derived from taxation on the speculative U.S. stock market bubble and the high-tech "New Economy," on which most states relied through the 1990s, have evaporated, leaving a combustible tinderbox.

A few national economic indicators show the accelerating downturn in the U.S. real economy over the third quarter (July-September) and October. The industrial production index fell 1.1% in October, a 13th consecutive monthly fall. Three key components of the index had huge third-quarter drops: semiconductors, 24.8%; industrial machinery, 15.9%; and textiles, 16.6%. September import/export trade figures, released by the Commerce Department on Nov. 20, show exports fell by 8.5% compared to August, with capital goods dropping by $1.6 billion, and industrial supplies and materials down by $1 billion. Imports fell 14%, which makes a six-month continuous fall. The impact of the shutdown of physical economy was writ large in October's 732,000 newly unemployed, bringing the (understated) official national unemployment to 7.7 million. These national figures are not divorced from state statistics, but rather reflect economic activity in all 50 states.

This depression trajectory was long in the making, and will not be ended by Federal Reserve chairman Alan Greenspan's interest rate cuts, done to feed the voracious bubble market economy; nor by Congress' pathetic "stimulus package" tax breaks, loans and payments to select corporations, and expanded unemployment benefits coverage.

Revenue shortfalls in the states are tied to three primary tax sources: personal income (PIT), sales, and corporate taxes. **Figure 1** shows states' total tax collections, nationally, have fallen by 3.4% in third quarter 2001 from third quarter 2000. The corporate tax component of this, fell a whopping 25%. States' sales tax growth rate has declined over the last six quarters, beginning second quarter 2000. The folly of tax cuts

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FIGURE 1
Year-Over-Year Change In Total State Tax Revenues, 1991-2001
(Percent Change)

*Partial
Source: State University of New York's Nelson A. Rockefeller Institute Fiscal Studies Program, Nov. 7, 2001 report.

at this volatile time should be obvious. The solution lies not in one-time cash infusions, but rather in restarting the productive economy, using directed low-interest credit for nation-building projects—Lyndon LaRouche's policy.

Fiscal Outlook: From Bad To Worse

The state brush fires began in January, leaving over one-third of them scrambling to balance their budgets by June 30—the end of their 2000-01 fiscal year. By the end of the first quarter of the new fiscal year (July-September)—and before the impact from Sept. 11 took hold—44 states were in trouble. The National Conference of State Legislatures' (NCSL) "October Update" found that 16 of these 44 states have *both* revenue shortfalls and spending overruns. But at least 28 states have or will cut their budgets or freeze spending as a result of the revenue shortfalls and expenditures overruns.

The budget-cut fire buckets, which governors, state legislators, and budget officials propose to use to keep the flames at bay until it rains, will in fact act like gasoline rather than water. Some states have reduced or eliminated pay raises for teachers and state employees, which sparked demonstrations at some state capitols—and will lower their revenue. Medicaid expenditures, the biggest budget-overrun item, are getting axed in many states, resulting in nursing home closures and mental health program cuts, as well as smaller benefits paid out to the elderly, disabled, and poor. A blowback of such cuts, is that states will receive still fewer Federal matching dollars. (The matching ratio had already been lowered by the 1997 Balanced Budget Act.) And even before October's surge in unemployment, 23 states' unemployment insurance funds were so low that Federal infusions will be needed to ensure benefits are paid.

Up until now states have done everything possible to avoid cutting school budgets in kindergarten through high school. But a recent Stateline.org news service survey reveals that 15 states have, or soon will cut these, too. "What we are seeing here is a downturn that was so quick that states did not see this coming," said Mike Griffith, policy analyst for the National Governors Association's Education Commission on States. More to the point, they were in denial as to the magnitude of collapse of the real economy. The cuts will include: no teacher raises, halting class size reduction plans, and even cutting school nurse programs. The 15 states are: Alabama, Arizona, California, Florida, Georgia, Idaho, Iowa, Massachusetts, Michigan, Mississippi, Nebraska, North Carolina, New York, Ohio, and South Carolina.

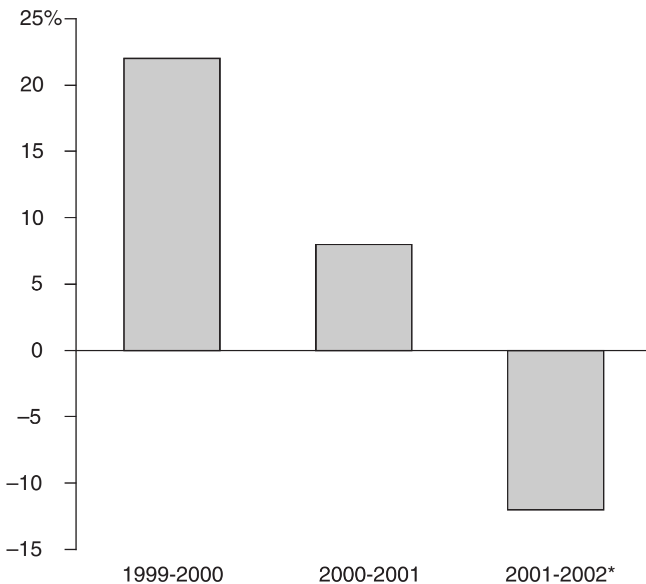
Ironically, when most state legislators were haggling out new budgets for this FY 2001-02, they had already factored in a slower rate of economic growth. But reality raced ahead; even the lower growth projections are too high. "Nationally, FY 2002 revenues were projected to grow 2.3% above FY 2001 actual collections, only half as much as the 4.5% actual revenue growth in FY 2001. It now appears that the modest revenue forecasts made for FY 2002 are unlikely to be met," the NCSL report understates.

Biggest State Economy In Big Trouble

EIR's May 4, 2001 feature on state budgets in crisis, showcased how California's shift away from reliance on revenues derived from the productive economy, to the speculative bubble non-productive economy, created the potential for a long-term effect of "permanently amplifying the magnitude of revenue loss to a crisis . . . beyond control." Indeed, on Nov. 14, the California Legislative Analyst's Office (LAO) issued its 30th annual Fiscal Outlook report. Its opening analysis states that the "deceleration" in revenue growth from FY 2000-01 to 2001-02, will be "the deepest one-year decline in the post-World War II period."

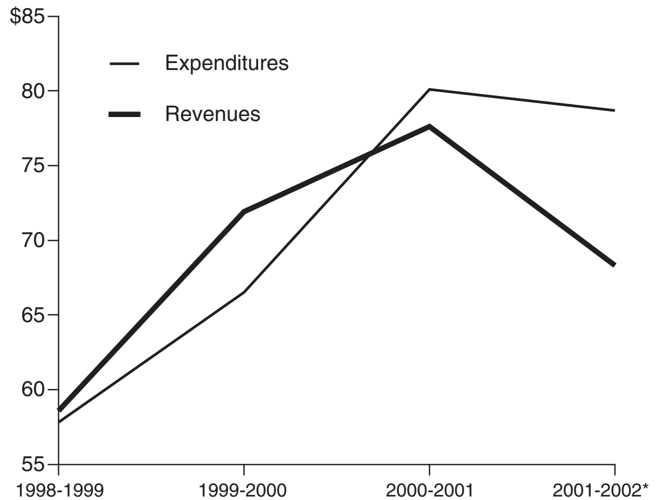
That one-year decline is 12.1%: from $77.7 billion total revenues in 2000-01, to $68.3 billion in 2001-02. *EIR* had detailed how the state's inordinate dependence upon revenues derived from the stock market and the high-tech information technology (IT) industry, made the state's wherewithal highly vulnerable as those failed. The impact of the "abrupt revenue fall-off is pushing the state into a major deficit for the first time since the early 1990s." **Figure 2** dramatically shows the decline. "In a nutshell, . . . after increasing 22% in 1999-2000, revenues decelerated to 8% growth in 2000-2001, and are projected to fall 12% in 2001-2002," which the Outlook shows will result in a $4.5 billion deficit, at the least, by June 30, 2002. That, wishfully, assumes a "recovery" will "begin next Spring." Even so, the following fiscal year's deficit is expected to be $12.4 billion!

FIGURE 2
California Revenues Plunge In 2001-02
(Annual Percent Change In General Fund Revenues)



*Projected
Source: California Legislative Analyst's Office, *Fiscal Outlook*, November 2001.

FIGURE 3
California: Gap Between Revenues And Expenditures, 1999-2002
(General Fund, $ Billions)



*Projected
Source: California Legislative Analyst's Office, *Fiscal Outlook*, November 2001.

EIR asked one LAO economist what the basis is for this recovery assumption. He replied, "It's what the mainstream national economists" are predicting.

Concretely, these multibillion-dollar shortfalls mean that the state of California will not have cash to pay its bills, unless it borrows monies. This is a risky proposition, as the state had already been threatened with having its bonds downgraded, when the manufactured energy crisis forced Gov. Gray Davis to spend $6-plus billion to keep the power on. That $6-plus billion hole has yet to be repaid to the General Fund, and negotiations to float $12 billion in state bonds to cover it are stalled.

The LAO report assumes no impact on the General Fund's condition from this outlay, because by law the "loan" must be repaid. But it notes, "the loan-repayment delay" has "fiscal implications from a cash-management perspective." That is, "the General Fund will have $6-plus billion less in cash than its budgetary balance." To bridge this gap, "the state will have to borrow an additional several billion dollars," and this poses "a special challenge" due to the "General Fund's projected large deficit."

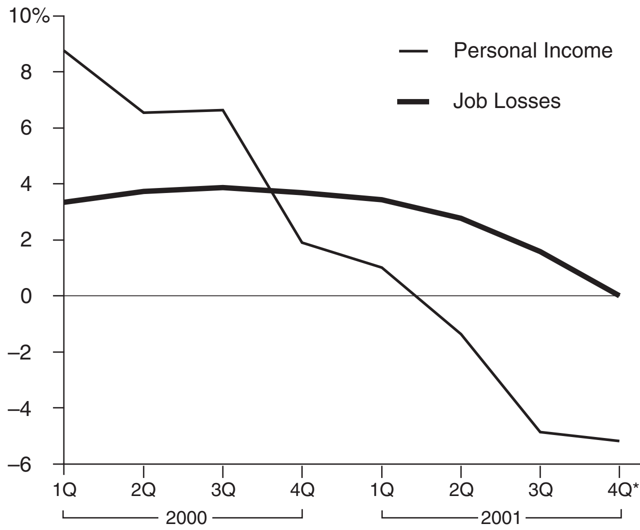
This is an understatement. California's current and projected deficits are so huge that the stability of its income streams with which to pay off its bond debts is in question. Were investors to sell these bonds, hoping to get a better return now, than later, this could lead to the blowout of the $1 trillion state and municipal bond market, and set off a financial shock wave.

The gap between revenues and expenditures is depicted in **Figure 3.** The gap is nearly $10 billion, with $68.32 billion in revenues expected to come in (plus $6.7 billion from the prior year's ending balance) against $78.7 billion budgeted to be spent and $800 million in other obligations. The resulting $4.5 billion deficit will leave no final balance at year's end, thus compounding the next year's deficit.

The revenue/expenditure gap means drastic budget cuts will be required. So far, Governor Davis has taken baby-steps, imposing a hiring freeze and asking Cabinet members to find $150 million in cuts—the two steps together total $260 million in savings as against a likely need to cut $3 billion this year. Reductions in education spending, assistance to local governments, and state layoffs are likely. The LAO report, operating in the confines of managing the fire, suggests "reduction or elimination of inflation adjustments for programs, permanent reductions in program service levels (such as reducing caseloads or limiting benefits), or permanent increases in fees or tax rates." But in current national depression conditions, these measures pour on the gasoline.

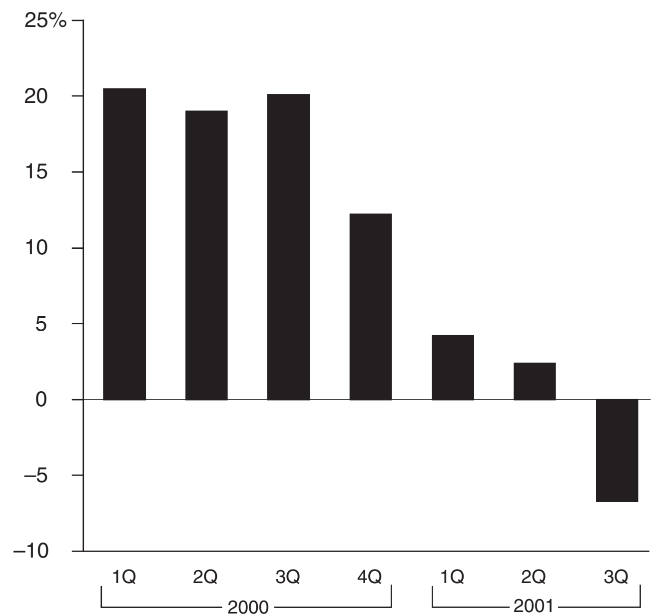
Unemployment increases in California in the pre-Sept. 11 period were largely in the manufacturing and business services sectors, "primarily related to cutbacks in computer and software industries," reports the LAO. Between January and September 2001, these two categories of employment lost nearly 100,000 jobs in the state. **Figure 4** shows the sharp

FIGURE 4
California Collapse Impact: Job Losses And Income Declines, 2000-01
(Year-Over-Year Percent Change By Quarter)



*Projected
Source: California Legislative Analyst's Office, *Fiscal Outlook*, November 2001.

FIGURE 5
California: Sharp Decline In Withholding Tax Receipts, 2000-01
(Year-Over-Year Percent Change, By Quarter)



Source: California Legislative Analyst's Office, *Fiscal Outlook*, November 2001.

trajectory of job losses and personal incomes as a percent change year-over-year. The personal income decline is the most dramatic, and directly reflects the blowout of stock markets and the IT sector. As the LAO puts it, the "substantial downturn," from 8.8% in 2000 to –5.2% in late 2001, is due to "dramatic decline in stock options-related earnings, which significantly reduced wealth, income, and spending." But worse, LAO wishfully assumes that "California will rebound when the national upturn ensues during the Spring of 2002."

There was a sharp 18% decline in withholding taxes collected through the first three quarters of 2001-02 over 2000-01 (see **Figure 5**). LAO states, "This . . . decline is . . . the steepest in the past three decades." Personal income taxes are the state's largest revenue source. *EIR* showed in May that the capital gains and stock option revenue components in 2000-01 comprised 22% of California's General Fund revenues! LAO assumes a 60% decline this year in these two revenue sources. Between May and September, cash receipts were $1 billion short of expectations.

As noted at the beginning, the rate of decline had already accelerated before the attacks; the cash deficit was $389 million in May-June and $600 million in July-September. No wonder there's a hole in the budget.

Other States To Keep An Eye On

While California is the most dramatic blowout, both in terms of magnitude and importance, recall that 44 states were already in trouble as of October, with 28 making or planning cuts this year. We touch on just a few of these other precarious situations.

Virginia's outgoing Gov. Jim Gilmore (R) suddenly found an $890 million hole in expected revenues, making a sham out of his pre-election accounting shenanigans to keep his GOP promise to cut car taxes. On Nov. 15, he blamed Sept. 11 for the newly found recession, while suspending the phaseout of car taxes and announcing 2% spending cuts in most agencies, as other state officials consider cuts in Medicaid benefits.

Illinois now expects at least a $500 million shortfall, and budget cuts will likely mean state worker layoffs.

Maryland's General Assembly budget analysts predict a two-year $1.7 billion deficit. Gov. Parris Glendening has imposed a hiring freeze and cut all agencies by 1.5% for starters.

New York's latest financial report states this year's shortfall is at least $1.5 billion, but is expected to go to $3 billion once the full "impact of the attacks" is counted. That is, there was a decline before Sept. 11. Gov. George Pataki's administration has said the state is experiencing the largest revenue declines since the 1960s, and that when the World Trade Center disaster's impact is factored in, they will be the worst losses since the Great Depression.