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Look at state finances for the real US budget squeeze

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If you pop into a toilet on the Seattle waterfront this summer, you might see over-flowing bins. The reason? A polite notice explains that "because of 2010 budget reductions", the Seattle government can no longer afford to "service this comfort station" each day. Hence the dirt.

Investors would do well to take note. In recent months, America's fiscal mess has assumed a rather surreal air. On paper, the country's federal-level deficit and debt numbers certainly look very scary. But in practical terms, the impact of those ever-swelling zeroes still seems distinctly abstract.

After all, so far the federal government has not been cutting spending; on the contrary, there was a stimulus bill last year. And, as my colleague John Plender pointed out this week, Treasury bond yields have been falling, as investors flee the eurozone woes. As a result, those scary numbers still seem to be problems primarily concocted in the world of cyber finance.

But there is one place where reality is already starting to bite in America - and that is in terms of state finances. Just look at the statistics. A report from the US Center on Budget and Policy Priorities issued last month estimates that in fiscal 2010 the US states collectively posted a $200bn-odd budget shortfall, equivalent to 30 per cent of all state budgets.

Last year, that pain was partly eased by Obama's stimulus package(s). But that spending splurge is now fading away. And in fiscal 2011 and 2012, the states are expected to face another combined budget deficit of $260bn, with the 2011 shortfall in places such as New Jersey, Illinois, Nevada and Arizona projected to be more than 35 per cent of last year's budget.

So far the municipal bond market has been dangerously complacent about all this, with yields on 10-year municipal bonds hovering slightly above 3 per cent. But, even if markets seem relatively relaxed, the key point is that the state statistics are already having a very real world impact - in contrast to the federal debt.

Never mind the trivial matter of Seattle's "comfort stations"; as it happens, Washington state's finances are better than most. In New Jersey schools, classes are being cut. In California, public sector employees are not getting paid. In New York, a subway extension has just been cancelled. And in places such as Illinois and San Diego, pension benefits are being renegotiated altogether, breaking numerous taboos.

This, in turn, begs a bigger question: what will be the wider economic and psychological impact? One obvious, immediate consequence of these cuts is that they appear to be undermining consumer confidence, over and above the damage already being inflicted by the stubbornly high unemployment rate. The pattern may also be fuelling some subtle shifts in terms of how investors view the future.

In Seattle, for example, local insurance companies have recently changed the message they are giving to customers. For though financial planners used to steer households into tax-deferred products (such as 401K), since they assumed that employees would pay lower taxes when they retired, the new mantra is "tax diversification". That is based on the idea that households should *not* defer tax payments, since taxes will inevitably rise in the future, as the fiscal squeeze takes hold.

And that, in turn, raises another question: namely what all of this real-world squeeze in Seattle (and elsewhere) might - or might not - do to the bigger debate about the federal debt. It is a fair bet that eventually the debate about state spending cuts will encourage investors and voters to start paying more attention to the seemingly abstract federal fiscal numbers.

That might spark more market upheaval. It might also create more political upheaval. Just look at the rise of the Tea Party for signs of that.

But if you want to be optimistic, it is also possible to put a more upbeat spin on this. For all the gloomy statistics about state deficits and spending cuts, what has not received as much attention is that some states are now trying proactively to tackle their woes. Illinois, for example, is facing a big crunch due to credit downgrades; but it is also doing some imaginative things, such as raising the retirement age for local state employees.

That may not please voters. Nor will it necessarily save Illinois from further downgrades to its debt. But this is the type of step that needs to be embraced at the federal level too. So if places such as Illinois can break these taboos, it could be a reason for cheer; conversely, if it sparks too much social unrest, it will be a powerful warning sign. Either way, holders of US Treasury bonds had better keep a close watch on what happens to state budgets this year; even in the all-too-tangible world of the Seattle waterfront.

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