Optimistic projections led to dramatic surge in California budget deficit

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Published: Tuesday, May. 15, 2012 - 12:00 am | Page 1A
Last Modified: Tuesday, May. 15, 2012 - 12:12 am

Gov. Jerry Brown announced Monday that the state budget deficit had grown by a remarkable 70 percent since January, but fiscal experts said the economy had little to do with it.

They instead blamed a bad marriage of volatile capital gains and political intransigence that led state leaders last year to count on a huge upswing in revenues that never materialized. At the same time, corporate tax changes from 2009 appear to have cost California more than state officials ever realized.

The Democratic governor says the general fund deficit has mushroomed from $9.2 billion to $15.7 billion. Most of the widening gap comes from acknowledging that his previous forecast was too optimistic, a concern that economists voiced last summer.

"I think the sense we were all getting last year was that we were getting to the end of our rope in solutions," observed Brad Williams, a fiscal forecaster who previously worked for the Legislative Analyst's Office. "This was what was left – an aggressive forecast."

The recession has had a lasting impact on a general fund budget that dropped from $103 billion in 2007-08 to $86 billion this year.

But nothing significant has changed in the California economy this spring to warrant such a dramatic growth in the deficit.

While housing and government jobs have yet to experience much recovery, taxes from paycheck withholding and sales are slowly growing. Export and high-tech sectors are robust.

"There's nothing wrong with the economy," said Chris Thornberg of Beacon Economics. "The problem here is the process. Simple as that."

The deficit also grew because federal judges and administrators rejected cuts to Medi-Cal and in-home care programs. The state owes more to schools in 2012-13 because of how funding formulas work, another symptom of the faulty revenue projection.
A year ago, Brown issued a different May budget on an upbeat note after state coffers overflowed in April 2011.

That tax boost put the state on a higher glide path, but Democratic lawmakers and Brown doubled down when May and June also saw more revenues and they could not persuade Republicans to support a tax measure.

They turned to more optimistic projections after the governor vetoed Democrats' first budget, which contained a sale of state buildings, use of First 5 early childhood money that has since been blocked by a judge and a questionable maneuver to pass a quarter-cent [sales tax] by majority vote.

Their eventual [budget deal] had the state counting on another $4 billion more in 2011-12. Brown's Department of Finance now predicts the state won't collect the $4 billion and will fall an additional $1.2 billion short.

Capital gains have become an increasingly significant part of California revenues over the past two decades, and with it comes instability in state revenues and forecasting.

The upcoming sale of Facebook stock is expected to net $1.5 billion for the state through June 2013, and possibly an additional $400 million if voters pass the governor's tax hike on wealthy earners.

Brown said Monday he thought last year's actions were "reasonable when we did it." He blamed the missed projection on the volatile nature of the state's tax system and called the state budget "a pretzel palace of incredible complexity."

Twice, he referenced JPMorgan Chase CEO Jamie Dimon, whose firm recently revealed a $2 billion trading loss, calling that "a big miss."

"The capitalist system is not coincident with your expectations of exactitude," Brown said. "It doesn't play out like we may want it to."

To balance this year's budget, Brown has proposed a mix of spending cuts, fund shifts and his $8.5 billion tax hike on sales and wealthy earners. Some of the deepest reductions hit poor Californians, such as stricter requirements in welfare-to-work, lower payments to Medi-Cal providers and a reduction in Cal Grants. He also has proposed trimming the 40-hour workweek by two hours for state workers.

Brown suggested Monday he was willing last year to take a chance to avoid more painful cuts.

"It's very easy to play gotcha, real simple," he said. "But when I have to cut and people lose their jobs, or a mother loses her child care, maybe her job, I'm reluctant to do that if there's a plausible reason why we might not have to. Now, it turns out in this case we didn't get the money."
Brown's tax measure could add more volatility to the state's tax system by relying more on capital gains of wealthy earners.

The governor said Monday it is an issue of fairness because a disproportionate share of income goes to the top earners.

Williams, who has consulted for attorney Molly Munger on a broader-based income tax initiative competing with Brown's, said the volatility of capital gains provides a political opportunity.

"It creates a no-holds-barred atmosphere where you can say, 'Well, heck, there's not really a sound basis for forecasting this, so why not be optimistic?' " Williams said. "The temptation is to be aggressive, so I think it takes some discipline out of the process."

To soften the impact if the state never collected that additional $4 billion last year, Brown and lawmakers agreed to create $2.5 billion in "trigger" cuts. The state employed only $980 million of reductions, even though current budget numbers say all of them should have been used. That would have meant $1.5 billion in K-12 cuts, equal to seven instructional days.

The reason schools were largely spared: Brown's Department of Finance issued a more optimistic forecast in December than the nonpartisan Legislative Analyst's Office. The LAO had said the state would never see most of the $4 billion and that it should use $2 billion in trigger cuts, while Finance believed the state would still get nearly half of the $4 billion.

Finance officials said Monday they didn't have crucial data from December and January showing a drop-off in quarterly payments when the governor issued his January budget. They suggested the winter drop-off was highly unusual for a growing economy. Capital gains actually declined in 2011 compared with 2010, possibly because the market experienced steadier growth in 2010.

Gabriel Petek, an analyst with Standard & Poor's, said state leaders last year "were kind of taking a little bit of a gamble." He said he would not expect lawmakers to use an aggressive revenue estimate of the same sort again.

"When we did look at the state's cash flow, we took the $4 billion off the table and assumed it wouldn't come in," Petek said. "A lot of people even at that point viewed it skeptically."
BALANCING THE BUDGET

How Gov. Jerry Brown would close an estimated $15.7 billion gap for the fiscal year that begins July 1 and provide a $1 billion reserve.

**SAVINGS**

**Health and human services programs**

**Medi-Cal:** Move recipients to managed care. Reduce payments to hospitals and nursing homes. $1.2 billion

**Welfare:** Reduce aid from four years to two. Create child maintenance program for kids whose parents time out and cut grant. $880 million

**In-home care:** Cut caregiver hours by 7 percent across the board beginning Aug. 1. Eliminate domestic services (shopping, cleaning, etc.) in shared households. $224.5 million

**Other:** Reduce funding for child support agencies. Decrease funding for developmental centers. $161 million

**Education programs**

**K-12 education:** Adjustment for overpayment to schools in current year due to decreased revenues. Eliminate transitional kindergarten. $1.5 billion

**Child care:** Cut provider reimbursement rates and eliminate slots due to new welfare criteria. $452 million

**Cal Grants:** Tighten grant eligibility for applicants after July. Restrict grants to colleges with lower default rates and higher graduation rates. $292 million

**Other education** $64.4 million

**Other programs**

**State workers:** Save 5 percent in compensation costs by shifting workforce to four-day, 38-hour weeks. $401 million

**Redevelopment:** Transfer assets of defunct agencies. $1.4 billion

**Judiciary:** Require courts to use reserve funds. Delay court construction program. $544 million

**State mandates:** Eliminate requirements (and payments) for local governments. $828 million

**Other reductions** $333 million

**REVENUE**

Taxes: Assumes voters in November approve sales tax increase and income tax increase on those earning more than $250,000 a year. $5.6 billion*

Other $339 million

**OTHER SOLUTIONS**

Loan repayment extensions $1.2 billion

Transfers and loans from special funds $612 million

Unemployment fund interest payment $312 million

Other $435 million

**Additional cuts if tax increase is not passed:** $6.1 billion

K-14 education $5.5 billion

University of California $250 million

California State University $250 million

Developmental Services $50 million

Local water safety patrol $10.6 million

Dept. of Forestry and Fire Protection $10 million

Flood control $6.6 million

Fish and Game $2.5 million

Park lifeguards $1.4 million

Department of Justice $1 million

Park rangers $100,000

*Only $5.6 billion of the $8.5 billion that Brown’s tax measure would raise would go to reduce the deficit. K-14 education would get the rest under Proposition 98.

Source: Governor’s Office Sacramento Bee