Budget counts on growth

Governor's spending plan could go awry if home market tanks, gas costs skyrocket.

By Andrew McIntosh -- Bee Staff Writer
Published 2:15 am PST Friday, January 13, 2006

The $125.6 billion budget that Gov. Arnold Schwarzenegger proposed this week predicts California companies will enjoy a robust surge in pretax profits during the next two years.

Economists warn, however, that a cooling housing market or rising energy prices - or both - could darken corporate California's otherwise bright outlook.

Finance Department projections, outlined in the governor's proposed budget, suggested pretax profits for California businesses will soar 10.4 percent to $150.5 billion in 2006.

Christopher Thornberg, a senior economist with UCLA's Anderson Forecast, said this and other projections do not appear to be overstated but added that the spending plan relies on forecasts "that are a little too rosy."

"If the economy continues to grow, the numbers will be fine," Thornberg said. "I think that a cooling of the real estate market has the potential to take the 'oomph' out of revenues, though."

The state's budget deficit may exceed current projections and corporate profits may not grow as much as expected if the booming real estate market and new home construction both start to sputter, he said.

"If it cools like I suspect it will, then they will have a larger deficit," Thornberg said.

The administration is already forecasting a $6.4 billion budget deficit in 2006-2007, rising to $6.6 billion in 2007-2008 and $9.7 billion in 2008-2009.

Sean Snaith, an associate economics professor and director of the Business Forecasting Center at the University of the Pacific in Stockton, said the governor's economic forecast is conservative and sound, matching those produced by his own center.

"The biggest wild card, to me, is not a calamitous collapse in the housing market," Snaith said. "There won't be one unless there's a sharp increase in interest rates. The wild card is energy prices."

"Energy prices fell at Christmas but only because we've had a mild winter," Snaith added. "They're starting to rise again, and demand from India and China will not subside. That's the biggest storm cloud on the horizon."

California gasoline prices reversed course abruptly this week, rising more than 16 cents a gallon after drifting lower almost every week since October.

The average statewide price for a gallon of regular, unleaded self-serve gas was $2.36, up from $2.20 on Dec. 30. Gas is selling for $2.45 in some markets and as high as $2.62 a gallon in South Lake Tahoe, according to a survey from AAA of Northern California.

That's an average of 40 cents more than California motorists paid for a gallon of gas a year ago. Higher gas prices also eat into corporate profits.

The administration's forecasters conceded in their economic outlook that rising energy costs and a slowing housing market will mean slower growth for both the state and national economies in 2006 and 2007.

"Consumers' debt loads are near record highs, and if energy costs are higher on average going forward, consumers will have less income left for spending," the governor's economic outlook stated.

The administration's forecast also predicts the number of new housing units authorized between now and 2007 will decline a total of 17 percent. New units will drop to 182,600 a year by 2007 from the 218,500 new units authorized in 2005, it said.

Despite warnings about slowing home sales and bigger energy bills, the administration forecasts taxable sales in California will hit $551.5 billion in 2006 and $579 billion in 2007, a 9.9 percent jump over the next two years.

David Hitchcock, director of state and local government finance at Standard & Poor's in New York, called the governor's forecasts reasonable and in line with those of private forecasters.

"The state is forecasting relatively robust corporate profits," Hitchcock said. "There's certainly a risk of a housing market slowdown there, but that may take some time before it has an impact on state revenues."

Thornberg of UCLA agreed, saying the impact wouldn't affect state ledgers until long after the governor's May budget revise.

Tim Blake, the California state investment analyst at Moody's Investor Service of New York, said his analysis of the proposed budget found it offers "a lot of good news to spending constituents."

Blake said Schwarzenegger's plan to boost education spending by $4.3 billion does nothing for the state's fiscal health but is rather "the governor's read of what he needs for the November election."

"They have the cash to cover it right now and the deficits are smaller than they were. Increased spending seems to be what voters want," Blake added.

The big issue for California's economy, and the state's revenue coffers, is consumer spending, Blake said.

"Will it hold up or will it flag? I can't predict it one way or another," he said.

The governor's forecast predicted that consumers here and across the country may find it difficult to keep spending, despite rising employment and personal incomes. Personal savings rates went into negative territory for the last two quarters for the first time since economists started tracking the data in 1947, forecasters noted.