

Daniel Weintraub: Riding the revenue rollercoaster up, again

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What a difference six months can make.

Last summer, Gov. Arnold Schwarzenegger and state lawmakers were haggling over a few million dollars here and a few million there as they struggled to close a deal on a state budget plan that would feature about \$90 billion in general-fund spending.

Since then, \$5.5 billion in unexpected tax revenues have flowed into state coffers. That's enough to pay the entire general-fund cost of the University of California and the California State University system, and more than twice as much as the state will spend on welfare grants this year. Looking ahead, the forecast for the coming fiscal year now includes \$5 billion more than the state's nonpartisan legislative analyst projected a year ago.

Those revenues reflect a resurgent California economy, with high-tech giants such as Google and Yahoo leading the way, old standbys such as Intel chipping in and thousands of smaller businesses doing their part. Profits are up, and in the past year, employment growth has started to keep pace, thanks in part to a housing boom that has kept construction workers and lenders busier than ever.

The structure of California's tax system and its economy mean that when incomes start to rise, the tax take rises even faster. And it looks as if we are riding that rollercoaster to the top again.

As the Department of Finance said in a recent budget document: One dollar of income on a high-income tax return can generate nine times more revenue than a dollar on a low-income tax return. That's because a person in the bottom tax bracket pays 1 cent of each additional dollar in personal income tax while a high-income person pays more than 9 cents in taxes on that dollar.

And in California, even more than in the rest of the country, income tends to be concentrated at the upper end of the spectrum, where the tax rates are higher. Those two factors - a graduated income tax and the concentration of income - mean the state is heavily dependent on taxes paid by its most affluent citizens.

In 2003, according to the Finance Department, the top 12 percent of state taxpayers - those with adjusted gross incomes of more than \$100,000 - paid 76 percent of the personal income tax.

Much of that money comes in the form of taxes on investment gains -- in business, the stock market and real estate. And just as we saw during the dot-com boom, investment income is responsible for much of the tax surge the state is getting now.

Since 2002, taxes on capital gains and stock options have increased from an estimated \$5.2 billion to \$11.3 billion, and are projected to climb to \$12 billion next year.

That run-up is similar to what happened between 1998 and 2000, when taxes collected from those same sources jumped from \$7.5 billion to \$17.6 billion in just two years.

The danger is that investment income - and the tax derived from it - is highly volatile.

Between 2000 and 2002, income from capital gains and stock options cratered, falling from \$196 billion to \$95 billion in one year, and then to \$58 billion the next. Taxes from those sources dropped by two-thirds.

Most experts don't expect a repeat of that scenario any time soon, for several reasons.

One is that revenue from stock options and capital gains accounts for about 13 percent of the state's general fund today. That's high by historical standards, but far less than the 25 percent of the budget those sources represented at their peak in 2000.

The general fund today is also a bit more diversified. Between 1998 and 2000, 79 percent of the new revenue in the budget came from taxes on capital gains and stock options. Between 2002 and 2006, only 36 percent of the new revenue has come from those sources. That suggests the current revenue base should be a bit more stable and better able to absorb a downturn in investment income.

The problem is that, unlike earlier this decade, the state is not running an operating surplus.

In the current fiscal year, which ends June 30, the government expects to spend \$2.6 billion more than it collects from taxes. In the year that begins July 1, Schwarzenegger is proposing to spend about \$6 billion more than the state takes in.

The difference would be covered by revenue left over from the recent surge in tax revenue.

But when that windfall is gone, the gap between spending and revenue is expected to live on.

A year from now, whoever is governor is likely to be facing a shortfall of about \$6 billion - with no spare cash to cover it. And that's assuming the economy continues to grow and suffers no shocks from natural disasters, terrorism or a bigger-than-expected slowdown in the housing market.

So while there is plenty to celebrate in today's economy - and the tax revenue it is generating - there is also a huge caution flag for state leaders, from the governor on down.

They need to get the state's finances in shape now, while times are good, or they could face disastrous consequences if the boom times end.