

# There are many culprits in \$10 billion budget mess

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A catastrophic convergence of events, ranging from a badly wounded national economy to the state's overreliance on revenues from its richest residents, has left California's budget drowning in a sea of red ink.

State officials are expected to formally announce today that the gap between spending and revenues in the budget for the current fiscal year has reached at least \$10 billion, and may reach \$25 billion by the end of the next fiscal year.

The announcement comes six weeks after Gov. Arnold Schwarzenegger and legislators patched together the budget with accounting tricks and one-time revenue boosts, and pronounced it balanced.

It also comes just two weeks after officials put the deficit at between \$3 billion and a worst-case \$5.5 billion while issuing \$5 billion worth of short-term notes so the state could continue to pay its bills through February. Another \$2 billion worth of notes are scheduled to go to market in November.

But economists and analysts within and outside state government say the deficit's skyrocketing growth can't be blamed solely on partisan political fights, or the budget being based on gimmickry, or inept or inartful forecasting by state budget experts.

Instead, they said, the near-collapse of the national economy combined with other factors over the past few weeks to drastically reduce the state's potential tax revenues in coming months.

H.D. Palmer, spokesman for the Department of Finance, said the department estimated a \$3 billion deficit by looking at how September's tax revenues, which were about \$1 billion lower than expected, would ripple through the rest of the fiscal year that ends June 30.

"What's happened since then have been rapid and unprecedented events," Palmer said, "that have caused us to develop new estimates for the special (legislative) session," which the governor says he will call after Tuesday's election.

Those events include the plunging stock market, the federal government's bailout of the financial industry, a dearth of credit at all levels, rising unemployment, the housing mortgage mess and very little consumer confidence in how things are going.

"It's a gloomy time," said Paul Warren, revenue and taxation coordinator for the Legislative Analyst's Office.

It's even gloomier for California because of the fact the state relies on personal income tax for nearly half its general fund revenues.

That comes back to bite California in tough times because most personal income tax revenues come from the wealthiest Californians: The top 5 percent pay 68 percent of the tax.

Much of the wealthy taxpayers' money comes from gains in the stock market and on other investments, and when the economy is down, so is their income.

The swings can be extreme. In the 1999-2000 fiscal year, for example, personal income tax revenue rose 28.1 percent. Two years later, it dropped 25.9 percent.

"When those taxpayers sneeze," Palmer said, "state revenues can catch a very bad cold."

In addition, revenues from corporate taxes are down because of the mired business climate, taxes from payroll withholding are down because of rising unemployment, and sales tax revenues are down because so are sales.

The governor announced Thursday he was establishing a 12-member state commission to overhaul the tax system.

"We are paying the price right now of this outdated revenue system," he said at a news conference in Los Angeles.

In Sacramento, meanwhile, administration officials were spreading the budgetary bad news Thursday to representatives of health and human services groups.

The representatives said they were told Schwarzenegger will ask legislators to make major cuts in health and human service programs. On Tuesday, the governor told education leaders to expect \$2 billion to \$4 billion in cuts. And on Wednesday, Schwarzenegger told reporters "everyone has to take a haircut" when it comes to cuts.

But the governor has also indicated he believes spending cuts alone won't close the gap.

He told the education group Tuesday he would propose a sales tax increase, similar to the proposal he made last summer. That recommendation was unanimously rejected by Republican legislators.

But a sales tax hike isn't the only revenue-raising idea being kicked around the Capitol.

Another is imposing an oil severance tax, which would tax oil extracted from wells within the state. California is the only oil-producing state that does not impose such a tax. A 6 percent tax would produce an estimated \$970 million a year.

Earlier this year, the Legislative Analyst's Office suggested closing a plateful of loopholes and exemptions in the tax system, as well as cutting tax credits. One example is reducing the dependent child credit on personal income tax forms from \$294 per child to \$94.

"The biggest problem we have is we have very little flexibility," said Warren of the Legislative Analyst's Office.

"We've used up over the past five years all the different kind of flexibility options we had available to us."

### **More Information**

- **KEY DATES IN THE STATE BUDGET CRISIS**

**Sept. 23:** Gov. Arnold Schwarzenegger signs \$103.4 billion state budget, 85 days into the fiscal year. The governor lauds reform proposals that "will finally put California's budget on a path toward long-term fiscal stability," he says.

**Oct. 15-16:** State Treasurer Bill Lockyer sells \$5 billion worth of revenue anticipation notes to keep the state's cash flow running. The notes' prospectus estimates the budget deficit at \$3 billion to \$5.5 billion.

**Oct. 27:** State Senate President Pro Tem Don Perata, D-Oakland, says the deficit may hit \$10 billion. Schwarzenegger says he will call the Legislature into special session.