

# Schwarzenegger orders plan for 10% budget cuts

The directive to all state agencies comes amid projections of a growing shortfall driven by the housing downturn.

By Evan Halper

Los Angeles Times Staff Writer

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SACRAMENTO -- — Gov. Arnold Schwarzenegger on Monday ordered all state departments to draft plans for deep spending cuts after receiving word that California's budget is plunging further into the red -- largely because of the troubled housing market.

State officials have warned the governor that the likely deficit for next year has jumped from a few billion dollars to as much as \$10 billion, threatening to wipe out the progress Schwarzenegger has claimed in getting the state's accounts in order.

In response, Schwarzenegger's finance department has ordered agency directors to formulate plans to cut budgets by 10% for the spending blueprint the governor will unveil in January, according to administration officials who spoke on condition of anonymity. That would mean substantial cuts in all state programs, including education, transportation and healthcare, the officials said.

The news is a major setback for the governor's other policy initiatives. His proposals to pass legislation this year that would bring healthcare to all Californians and address the state's water problems were already faltering in the Legislature. News of a massive looming deficit will make the proposals, both of which would require billions of dollars of new spending, politically less palatable to lawmakers.

The state's mounting financial problems will also make California less attractive to Wall Street, which could downgrade its credit rating.

Economists say the state's declining fortunes are due in large part to the shakeout in the housing market and a volatile revenue system overly reliant on income taxes. As state officials discovered last time the economy went into decline, any downward shift leaves California's general fund reeling.

Administration spokesman Adam Mendelsohn declined to answer questions about the directive issued Monday. He would say only that internal budget discussions were continuing.

"Whatever we are doing now is all part of the deliberative process internally to make sure we are best prepared for whatever situation presents itself," he said. "We are continuing to look at revenues as they come in."

Economists warn that the administration should prepare for more bad news.

"We are among a handful of states that has a lot of exposure to the housing crash," said Ted Gibson, a former state economist. Property taxes, income taxes and sales taxes are all off as a result.

Democrats were already girding for a fight over the administration's budget reduction proposals -- and hints from administration officials that they might ask schools to sacrifice some of the money they are guaranteed under voter-approved spending formulas.

Sen. Darrell Steinberg (D-Sacramento), who sits on the Senate Budget Committee, called on the governor to consider reining in not just spending, but also tax breaks for businesses.

"If we are going to talk about the spending side, which we must, we should look at tax credits and that side of the ledger as well," Steinberg said.

It was less than a year ago that the governor was presenting a budget plan that he boasted would leave the state with an operating deficit of "zero." But the budget that lawmakers ultimately passed in August included a shortfall of \$6.1 billion for lawmakers to contend with in the coming year. Since then, the situation has worsened.

Recently, administration officials acknowledged that receipts through September -- just three months into the fiscal year -- were about \$1.5 billion below projections.

The administration's plan to bring \$1 billion into state coffers through the privatization of EdFund, a government agency that backs student loans, may not take place this year -- and may not bring anything close to the funds state officials had hoped.

The administration had been relying on increased property tax payments for an additional \$1.3 billion in revenue. Experts warn that, at a time when home prices are dropping and homeowners are demanding reassessments of their property taxes, most of that money is unlikely to materialize.

The state is also being forced to confront the consequences of not saving money when times were better.

When the economy improved nationwide several years ago, most states erased chronic deficits and began building rainy day funds. California did not. It continued to spend more money than it

brought in.

"We never fixed the problem," said Chris Thornberg, a principal with Beacon Economics. "It's been Scotch tape and glue and staples and just praying we will never have to face the reality that state government is on a path that is not sustainable."

Thornberg said the trouble in the housing sector is reverberating through the entire state economy, causing income and consumer spending to decline. He noted that unemployment is up a full percent since the beginning of the year, a jump that typically foreshadows recession.

"What's happening right now is big in terms of the revenue hit," he said. "The numbers are coming in way below where they should be."

The growing deficit, Thornberg said, will also probably create trouble for California on Wall Street, where bond rating agencies typically punish the state if the budget falls too far out of balance.

"I think we're going to see a downgrade," he said. A lowering of the state's credit rating, already one of the lowest in the country, will make it more difficult -- and more costly -- for the state to borrow money.

Mendelsohn, however, denied that the state's financial woes threaten to throw the governor's agenda off track. He said that though California may be short on cash, the state can't afford not to address the issues on the governor's agenda.

"The question people have to ask themselves is what will happen to the economy without a water plan," he said. "The failure of our healthcare system is costing taxpayers money."

But many in the Capitol suggest the governor will need to scale back his policy goals if the budget shortfall continues to grow.

"Every time the economy catches a cold, the state budget catches pneumonia," said Republican political analyst Tony Quinn.

"It just hits it so hard. . . . And then we have a period of political paralysis."

[evan.halper@latimes.com](mailto:evan.halper@latimes.com)

Times staff writer Nancy Vogel contributed to this report.