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## Can California's money mess be fixed?

By Dennis Cauchon, USA TODAY

SACRAMENTO — Can Arnold Schwarzenegger fix California's financial mess? Can Cruz Bustamante? Can anyone?



California Gov. Gray Davis talks with volunteer Griselda Mariscal at AFL-CIO offices Tuesday.

By Hector Mata, AFP/Getty Images

Whoever emerges from the state's recall election next Tuesday as governor must persuade the Legislature to cut spending or raise taxes by about \$10 billion a year — 10% of California's \$100 billion annual budget. That means raising taxes about \$300 per Californian — or reducing spending, by that amount, on education, health care and other services.

The state's inability to manage its money has brought Democratic Gov. Gray Davis to the brink of recall. For nearly three years, the nation's most populous state has spent roughly \$1 billion a month more than it has taken in. A new budget for the 2004 fiscal year, signed by Davis in August, continues this hemorrhaging.

### HOW TO BALANCED BUDGET?

California Gov. Gray Davis and the major candidates to succeed him if he is recalled have proposed ways to attack the state's budget deficit. Highlights:

The solution for the Golden State, as Republican candidate Schwarzenegger says, is simple enough for his

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**Gov. Gray Davis (D):**

- Earlier this year allowed legislation passed under a previous governor to reinstate a \$4 billion annual car tax that had been cut in 1998.
- Proposes to shift billions of dollars in social services costs to local governments.

**Gov. Cruz Bustamante (D):**

- Proposes to increase taxes by \$8 billion a year.
- Raise the top income-tax rate from 9.3% to 11%.
- Ask voters to modify the state's property-tax limit.
- Make unspecified spending cuts totaling billions of dollars.

**State Sen. Tom McClintock (R):**

- Repeal the \$4 billion car tax.
- Reduce fraud and inefficiency.
- Void expensive electricity contracts.
- Replace state workers compensation law with less expensive one.

**Arnold Schwarzenegger (R):**

- Repeal the \$4 billion car tax.
- Pledges not to raise taxes or trim education spending. Would make deep cuts elsewhere.
- Would stop paying legislators until budget is balanced.

*Source: USA TODAY research*

oppose spending cuts, Republicans oppose tax hikes — and both oppose compromise.

The governor — disliked by many legislators and unpopular in opinion polls — has had little clout to force a solution.

Voters themselves have provided little guidance. Polls show that Californians oppose spending cuts *and* higher taxes.

**Huge capacity to borrow**

California has been able to delay balancing its budget because it had a huge capacity to borrow money. Before the budget problem, it carried a relatively small amount of debt for a state its size. Its \$24.8 billion in debt in 2001 was equal to \$733 per person compared with a national average of \$820, according to Moody's Investor Service. A constitutional requirement that voters approve most debt had kept borrowing down.

That's all changed. The state must borrow \$18 billion in bonds, notes and loans during the next nine months alone to continue operating normally. The state's lawyers say they have found language that gets around the restriction on borrowing without voter approval.

The state's real deadline for solving its budget problem will be when it exhausts Wall Street's willingness to lend money — a finale that could come in a few months or not for a few years.

"I look at the state treasurer's Web site every day to see how he's doing rounding up cash," says Daniel J.B. Mitchell, a UCLA management professor. "If these bond

6-year-old daughter to understand: "Not to spend more money than you have." But a new governor might discover what the old governor already knows: The problem is easier to describe than to solve.

"California's budget problem is primarily a political problem — an inability to compromise," says pollster Mark Baldassare of the non-partisan Public Policy Institute of California.

The Legislature has been stuck in budgetary gridlock since the state's finances began to deteriorate in 2001 as the high-tech industry in California's Silicon Valley crashed. Democrats



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offerings fall apart, the state would quickly run out of cash. Then you have a real crisis."

The state could be forced to lay off workers, close universities, curtail medical care for the poor and default on debt — at least until an emergency spending bill was passed.

So far, investors appear ready to lend the \$18 billion the state needs to keep going. "I haven't seen any indication that California will have a problem in the credit market," says Claire Cohen, an analyst at Fitch Ratings, a bond rating service. "Still, it's a lot of money, and when you rely on borrowing to pay your bills, you have some vulnerability."

### **Roots of the problem**

In May 2000, Gray Davis held a news conference. The governor had good news. The state would experience a one-time \$12 billion windfall in revenue. The money was the state's lucky break from an income tax boom largely driven by Silicon Valley executives and employees cashing in stock options at the peak of the high-tech boom.

The governor was clear: This money was a one-time thing that should be spent on one-time expenses such as building roads and schools, not on expanding ongoing programs.

"I intend to resist the siren song of permanent spending whether it comes from the left or the right, and I will stand up to anyone who tries to convince the Legislature that they should spend most or all of this money in ongoing expenses," the governor declared.

Within a few weeks, however, the governor and Legislature agreed to spend \$10 billion of the windfall on permanent tax cuts and spending increases for education, health care and state workers. These commitments — equal to the size of the state's annual deficit — continue to this day.

"He could have said no. He said he would say no. And he did it anyway. He couldn't resist, and the rest is history," says Dan Walters, a veteran political columnist for the *Sacramento Bee*. "This was absolutely preventable. Gray Davis has only himself to blame."

Stephen Peace, Davis' budget director, defends the governor: "Only one person has put forward a plan that solves the budget problem. The governor did, in January, but the Legislature made clear it wanted to solve the problem over several years, not all at once."

The 120-member Legislature also was warned in 2001 by its Legislative Analyst's Office, which advises legislators on budget issues, against adding too much permanent spending in response to a temporary boom in tax revenue.

"We need to improve our ability to reserve money in good times," Peace says. "It's hard to do because neither Republicans nor Democrats nor, frankly, the public wants to let the money sit there."

State spending increased 13% in the fiscal year that ended June 30, 2000. It rose 12% in 2001 and 10% in 2002. That was the third-fastest spending growth by a state during those three years and nearly twice the national average. Audited results for fiscal 2003 are not available yet.

Some of this spending increase actually paid for tax cuts; the Legislature cut local taxes, then had the state reimburse local governments for the lost revenue. But most of it was old-fashioned spending on popular programs, especially public safety and health care. Other factors driving up spending:

- The state has kept hiring workers throughout the budget crisis, despite an official hiring freeze. State employment was a record 457,800 in July, up 43,000 from 1999.

- California improved state employee pensions in 2000, expecting pension fund investments in the stock market to pay for new benefits. Instead, stock prices fell. Now the state must pay \$3 billion to fulfill its pension obligations this year. It will borrow \$2 billion to pay one pension fund and delay a \$500 million payment to another.
- Ballot initiatives approved by voters mandate spending. Schwarzenegger, for example, led a successful campaign last year to expand before-and-after-school programs. It could cost up to \$455 million a year but won't take effect until the economy improves. The governor's budget office estimates that \$31 billion in spending nearly one-third of the budget this year is driven by ballot initiatives over the last 11 years.

"A lot of the budget is on auto-pilot," says Ted Lascher, a political scientist at California State University in Sacramento. "The California electorate is relatively liberal, and voters have obligated a lot of money for services."

### **A national trend**

California isn't the only state having big financial problems this year. The weak economy slowed growth in tax revenue nationwide. States, which spend about \$1 trillion a year, had to cut back about \$50 billion in planned spending increases this year, according to the National Conference of State Legislatures. Many states borrowed heavily and raised taxes and fees modestly to balance budgets.

But California's budget problem is the worst in the nation. The state's failure to deal early with its revenue decline has caused a financial hole of historic proportions — and a political meltdown that has led to the first attempt to recall a California governor.

The state has taken only one major action to balance its budget in the last three years. Effective today, Davis eliminated a \$4 billion-a-year tax cut that lowered the fees residents pay on their cars.

The governor says the 1998 tax cut law automatically reinstates the "vehicle license fee" if the state suffers a revenue shortfall. Opponents of the tax have sued, and many candidates for governor have called for its repeal.

The major candidates vying to succeed Davis — if he is recalled — have offered few specific remedies. Instead, they rely heavily on promises to save billions by reducing waste and fraud.

"There's no line in the budget that says 'waste' or 'fraud,'" says Jean Ross, head of the California Budget Project, which supports higher taxes over spending cuts. "It's easy to understand why candidates try to be vague. Crafting a budget that stands up to scrutiny is incredibly difficult."

Fiscal conservatives say California taxes and spends too much. They cite recent studies showing that more businesses and residents are leaving California than moving to the state, a reversal of the state's historic growth.

They also cite the state's huge spending growth in the past five years. It has risen 9.1 percentage points annually above the combined rate of inflation and population growth, a common index of spending growth.

"The logical thing to do would be to freeze spending, identify low-priority programs and cut them," says Larry McCarthy, president of the California Taxpayers Association, which opposes tax increases. "It would devastate the economy to try to tax our way out of this mess."

But advocates of spending for social programs say California's taxes are reasonable. They argue that the government is actually smaller than 10 years ago when factors such as inflation, population growth and rising incomes are considered. "If you look at where spending increased, it was in education, health care and tax relief," Ross says. "That clearly mirrors how people think their money ought to be spent."

## Myth or reality?

The popular perception that California is a state where taxes and spending are sky-high may not be accurate.

A USA TODAY analysis found that California is at neither extreme in taxing or spending. California ranks ninth among the 50 states in the amount state and local governments tax and spend for each resident, according to an analysis of Census Bureau data.

California, however, is a wealthy state, ranking eighth in personal income. The portion of income that Californians pay to state and local governments is average — the state ranks 22nd in revenue collected as a percentage of income.

But California's taxing and spending policies are unusual in critical ways:

•**Property taxes.** California has the nation's second-highest property values (behind Hawaii) but low property taxes. Only Alabama and Hawaii have lower tax rates as a percentage of a home's value. Proposition 13, approved by voters in 1978, slashed property taxes by 53%. It limits annual taxes to 1% of a property's value in 1975 or the most recent resale value, plus small increases for inflation. The law helped protect homeowners from being crushed by higher taxes driven by soaring real estate values.

Proposition 13 makes California heavily dependent on the income tax, a lucrative but volatile revenue source. The shakeout in California's high-tech sector has hurt two ways. Almost 200,000 jobs in Silicon Valley have vanished since 2000. And stock market declines made stock options virtually worthless, cutting the amount of income taxes collected when employees sold company stock.

•**Spending priorities.** The state ranks 40th in spending on kindergarten-through-12th grade education — its biggest expense — when measured as a percentage of personal income. But it spends more money than other states on health care for the poor and public safety.

California has one of the nation's most generous health care systems for the poor. The state's Medicaid program covers 6.2 million people — 18% of the state's population, a greater percentage than all but four much poorer states and affluent Vermont. It also covers more services than most other states. Because California is a wealthy state, the federal government reimburses only 53% of the cost, the minimum. In poor states, Washington pays up to 80%.

California spends about 30% more per capita than other states on police and prisons. One reason: Voters in 1994 approved a "three strikes" law that sends criminals convicted of three felonies to prison for life without parole.

But Davis may have hurt his image, and the state's, by releasing a projected two-year deficit figure — \$39 billion in its latest version — that opponents latched on to as a clear reason to ditch him. Though a \$10 billion-a-year deficit is reality, national pundits pointed to the larger figure in shorthand to illustrate California's liberal spending ways. The \$39 billion was predicated, however, on fulfilling all the spending commitments that the governor and Legislature wanted over the next two years — commitments that couldn't realistically be met.

## No easy fix

Raising taxes in California won't be easy.

The state's top income tax rate of 9.3% is the nation's third-highest and starts at just \$39,000 of taxable income, according to the Urban Institute. The state sales tax is 6%, tied for sixth-highest in the nation. It reaches 8.5% in some cities when local taxes are included. The top corporate income tax rate is 8.84%, eighth highest.

Billionaire investor Warren Buffett, an adviser to Schwarzenegger, suggested that

Proposition 13 should be reconsidered. But the candidate says he won't support changing the tax limitation. Polls show Proposition 13 is as popular today as when it passed in 1978.

The bottom line: Taxes that legislators can raise are already among the highest in the nation. The one tax that is low, the property tax, is low because voters want it that way.

"Californians, especially frequent voters, have lost confidence in the ability of government to manage money," says Baldassare, the pollster. "It's hard to sell a tax increase in that environment."

Another barrier to raising taxes or cutting spending is the state constitution. It requires two-thirds of the Assembly and Senate to approve budgets. Only Arkansas and Rhode Island share this super-majority requirement.

Walters, the political columnist, says the biggest obstacle to fixing the budget is the way legislative districts are drawn. The state has been carved with computer-aided precision into districts that are safe Democratic seats and safe Republican seats.

"The only election that counts in California is the primary," he says.

The result is a dearth of political moderates such as those who played key roles in solving budget problems under former governors Ronald Reagan, George Deukmejian and Pete Wilson, Walters says.

Now, Democratic legislators are staunchly liberal and indebted to public employee unions. Republicans are staunchly conservative and rely on anti-tax groups.

Peace, the governor's budget director, says the state has until July to solve its budget problem. That's when the new budget year begins and this round of borrowed money runs out.

James Lyons, 54, of Pasadena, Calif., knows the pain massive budget cuts would have. He was laid off from his state job as a disaster-assistance specialist in July.

His income fell from \$1,100 a week to \$370 in unemployment compensation. A dialysis patient, Lyons saw his insurance costs rise from \$42 a month to \$380.

The state laid off 1,900 workers in July. It also hired 3,000.

"Other departments have resisted and resisted," he says. "My department just gave us up. Budget cuts are never fair or easy."

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