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State Spent Its Way Into Budget Crisis

■ Davis, legislators of both parties lavished windfall on programs. Analysts see years of pain ahead.

By Jeffrey L. Rabin, Times Staff Writer

During Gray Davis' term as governor, California's state budget has gone from a record surplus to a record deficit.

When the state treasury was flush with cash, the governor and lawmakers from both political parties pushed state spending to new heights. In part, that money was spent to expand programs—especially in education—that locked the state into future spending.

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But when the economy faltered and revenue sank, the governor and the Legislature kept spending at near the levels they established early in Davis' term. So now, instead of having billions in the bank, the state is borrowing billions from the future to pay today's bills.

Republican Bill Simon Jr. has criticized Davis for his handling of the state budget, saying that he would bring smarter fiscal management to a state that has seen its fortunes reverse in recent years. Indeed, California's deep fiscal problems will be a front-burner problem for the next governor—no matter who wins Nov. 5.

The seeds of the state's budget difficulties were sown in Sacramento and on Wall Street.

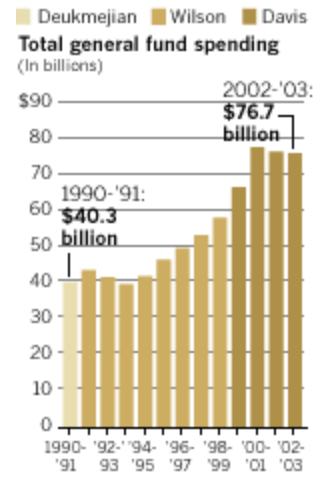
When Davis took office in January 1999, the stock market was climbing toward a historic peak. The state's high-tech economy was turbocharged. Silicon Valley was booming.

The surging stock market pumped new money into state coffers, helping to build a surplus of \$8 billion in 1999-2000.

Graphics

State spending

State general fund spending soared to record levels in the first two years of Gov. Gray Davis' administration, but dropped slightly in the last two years. The rapid growth in spending began with Gov. Pete Wilson after the state's last deep recession.



Source: Legislative Analyst's Office
Los Angeles Times

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State income tax receipts just from taxpayers exercising stock options and taking capital gains on the sale of assets more than doubled from nearly \$8 billion in 1998-99 to \$17.6 billion in 2000-01.

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State Finance Director Tim Gage said administration officials understood that the windfall from stock options and capital gains would not last forever and tried to set aside a portion of the extra money for one-time spending programs.

Even so, the governor and lawmakers responded to the state's good fortune by embracing sharply higher spending, particularly for education. The state also embarked on a major expansion of health coverage for uninsured children, more college scholarships and raises for state employees. Lawmakers also gave back money to taxpayers in the form of reduced motor vehicle fees.

In the first two budgets of the Davis administration, the state's general fund spending shot up by \$20 billion, accelerating a growth trend that began in Gov. Pete Wilson's second term. Those spending plans won approval with solid support from Republican lawmakers.

Susan Kennedy, cabinet secretary to Davis, said that when Davis became governor, he was determined to address "16 years of pent-up demand" for school funding, transportation and health care for uninsured children.

During Davis' tenure as governor, state spending for kindergarten through high school education increased by \$15 billion to \$56 billion, a 37% jump.

Per-pupil spending on California public schools has risen from \$5,756 to \$7,067 a year, a 23% increase since the last budget of the Wilson administration. From near the bottom, Davis administration officials said, California's spending per pupil has climbed toward a middle ranking compared with other states.

Student fees for California residents at the University of California, state colleges and universities, and community colleges were cut 5% during Davis' first year in office—with the state government stepping in to make up the difference. The reduction followed a similar decrease in the last year of Wilson's governorship. Those fees have not gone up.

In an effort to extend health coverage to uninsured California children, enrollment in the state's Healthy Families program has increased more than twelve-fold to 624,000. The program is expected to cost the state \$672 million this year, more than six times the amount in Wilson's last budget.

During the boom years, lawmakers also reduced the fees charged at state parks and enacted tax breaks for business, teachers, research and development, child care and elder care.

But when the tech bubble burst, the income tax windfall from stock options and capital gains abruptly ended. State revenue plummeted by 15%, the largest drop since the Great Depression. And the state's cash reserves were being eroded by \$6 billion on spending for power purchases during the energy crisis.

"The speed with which the revenue dissipated was just shocking," said Tom Lieser, senior economist with the UCLA Anderson Forecast.

Since the peak in early 2000, the stock market's steep slide has slashed income tax receipts by more than \$10 billion, according to an estimate from the legislative analyst's office.

Finance chief Gage said the stock market dive caught everyone by surprise. "No one saw this coming, at least not to this magnitude."

While the downturn depressed revenue in many states, California and its high-tech economy suffered a particularly hard blow.

Over the years, economist Lieser said, the state's income tax has become the most important revenue source, providing half of the funds needed to support general fund programs. Sales, bank and corporation taxes are the other major sources of revenue.

"We seem to have become more dependent on high-income taxpayers," he said.

The legislative analyst has reported that more than 40% of all of the adjusted gross income in the state is earned by the top 5% of taxpayers.

That makes the state treasury more vulnerable to economic slumps that depress income and revenue from taxes on capital gains and stock options.

"The capital gains part has been a bit of a wild card," said Legislative Analyst Elizabeth Hill.

"There has been real volatility in that element of the personal income tax."

Hill has warned that without legislative action to boost revenue or cut spending, the state's financial problems will persist for years to come.

On the campaign trail, Simon has been sharply critical of Davis, saying the governor has "completely mismanaged the state budget."

"He turned a record budget surplus into a record budget deficit," Simon said during the debate with Davis this month in Los Angeles.

At campaign stops, Simon ridicules Davis for a 36% increase in state spending over three years—more than double the rate of inflation and growth in population.

The GOP candidate calls such rapid growth in spending "a prescription for disaster."

Davis defends his record, noting that the state's "schools are getting better" and many more children have health care.

Administration officials also point out that spending always fluctuates with the economy and note that there were rapid spending increases during the tenure of Republican governors, including Wilson and George Deukmejian.

For Davis, the budget problems peaked this summer, when he and the Legislature were confronted with a \$23.6-billion shortfall.

To close it, the governor and lawmakers relied primarily on a series of stopgap measures, including the use of extensive borrowing, to produce a \$98.9-billion budget. In the process, they broke another record: The budget was 67 days late.

One area where the state has borrowed from the future involves tobacco settlement money. This year's budget includes \$4.5 billion in future tobacco settlement money to pay current bills. Otherwise, much of that money would have gone to support health programs in future years.

Gage defended the decision to borrow against the tobacco settlement money. "We needed to help cushion the blow of a significant and abrupt decline in revenue," he said.

The budget adopted in September also relies on speeding up some tax collections and pushing some expenditures into the next fiscal year.

After a yearlong hiatus, the state's financial woes triggered a quarter-cent sales tax increase last January.

To help ease the budget crunch, tax credits for teachers and businesses with net operating losses have been temporarily suspended.

Davis acknowledged when he signed the budget that "it is not a perfect document." But the governor insists that he took a balanced approach to the spending plan.

"The budget I signed did not have any tax increases, and in fact, did protect our priorities of public safety, public education, vital programs for seniors and our Healthy Families insurance programs," he said during the debate. "I had some revenue increases, and I had some cuts, and I had some one-time deferrals."

Davis said Simon has been vague about his solutions for the state's budget problems and has failed to offer specifics about where he would cut expenditures.

Despite the state's economic woes, neither side in Sacramento has rushed to cut spending.

Instead, said Stephen Levy, director of the Center for the Continuing Study of the California Economy in Palo Alto, Davis and lawmakers in Sacramento have engaged in "massive ostrich behavior."

"They really refused on a bipartisan basis to do anything but pray and borrow from the future."

The latest overall state budget, including all spending, was trimmed by about 2.4%, or almost \$2.4 billion from the previous year. The general fund, which supports most programs such as schools, higher education, law enforcement and prisons, was cut a scant 0.2%, or \$141 million.

Although UCLA economists foresee a modest improvement in the state's economy next year, Lieser said Sacramento is not out of the woods. "It's going to be a very frugal fiscal environment for several more years," he said.

Assembly Republican leader Dave Cox (R-Fair Oaks) was among those legislators who approved the burst of new spending early in the Davis administration. But when the revenue picture darkened and "it came to managing the problem of the budget," Davis was "just slow to act," Cox said.

He and most other Republican lawmakers refused to vote for the last two Davis budgets.

Cox likes to simplify the differences between the two political parties over the budget. "One side believes it's an expenditure problem. The other side believes it's a resource problem," he said. "Our side believes smaller government is better. The other side believes bigger government is better."

That brought a sharp retort from Davis' cabinet secretary, who said Republicans like to talk about spending cuts but don't like to vote for them. "The Republicans who say it's an expenditure problem should put up or shut up," Kennedy said.

Economist Levy predicted that the budget crisis will be back the day after the election because Democrats and Republicans in Sacramento failed to come to grips with the fundamental imbalance of revenue and spending.

"The party of investing colluded with the party of fiscal responsibility in this little boondoggle," Levy said.

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