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Budget Balanced on Faulty Figures

■ As election neared, state leaders ignored warning signs of a faltering economy and made erroneous assumptions about future revenue.

By Jeffrey L. Rabin, Times Staff Writer

Last August, Gov. Gray Davis and members of the Legislature were in a bind: The state budget was two months late, election day was fast approaching and they still had a gap of more than \$10 billion to fill.

Rather than confront the magnitude of that challenge, however, California's elected leaders resorted to budget tricks, ignored evidence that the economy was faltering and made false assumptions about future revenue and the effect of proposed spending cuts. The result was a budget that was out of balance as soon as it was signed. And the spending plan has continued to dip into the red, deepening the current fiscal crisis.

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A review of economic indicators and budget documents from last year reveals a host of ways in which state leaders papered over California's fiscal difficulties in an election year.

Among them:

During the budget negotiations, Davis' administration changed how it portrayed the state of

the economy. Rather than use figures that compared one calendar year to the next, the administration, without fanfare, shifted to presenting results that compared the fourth quarter of 2002 to the same period a year earlier. The effect was to make the economy look significantly better than it otherwise would have just as Davis was seeking reelection.

The budget approved in September was built on out-of-date economic assumptions drafted in May. Even though the economy weakened through the summer and new information cast doubt on the revenue and spending projections, officials made no effort to update them. Using those incorrect projections left the state with billions of dollars less revenue this year than the budget



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anticipated.

With the economy struggling and the stock market falling, taxpayers were entitled to larger income tax refunds than they would have received in more prosperous times. Even though that pattern was clear last spring, the state did not properly budget for refunds. As a consequence, the state paid \$2.4 billion more in personal and corporate tax refunds than was included in the budget.

In the closing days of budget talks, officials eager to end a long standoff assumed that the federal government would increase its support for California by \$1 billion in 2002-03, and projected that an early retirement offer and spending cuts would save the state another \$1 billion. Both of those assumptions were backed by little evidence and proved largely false, leaving the state \$1.7 billion more in the hole.

"They tried to tiptoe through the summer ignoring the bad news," said Ted Gibson, former economist for the state Department of Finance. "The choice that was made by all concerned was to sweep everything under the rug beginning in June."

Today, California is paying for the politicians' budget tactics last year. The Davis administration now concedes that the deficit in the fiscal year that ends June 30 is at least \$11.4 billion. And the projected shortfall for next year, by all accounts, is even larger.

The May Forecast

The budget deliberations began last year in January, but the state produced its key economic estimates in May, when the governor released his revised budget proposal for 2002-03. That document, as it traditionally does, estimated spending and revenue for the fiscal year, basing those figures on factors such as employment, income growth and the condition of the stock market.

But last year, the Davis administration presented those estimates differently than it and other administrations had in the past.

In previous years, the estimates included in what is known as the "May revise" were based on the economy's annual performance for the year before and estimates of its performance in the year to come. In 2002, however, the Davis team crunched the numbers by comparing the economy in the fourth quarter of one year to the same period a year earlier.

The effect of that subtle shift was profound, both economically and politically.

Had Davis, then in the midst of a reelection campaign, used the annual figures, they would have shown that the number of jobs in California was expected to drop 0.5%. And the growth in income would have been just 1.5% during the same period -- paltry numbers for a governor defending the state of the California economy on his watch.

The fourth-quarter-to-fourth-quarter figures were significantly more upbeat. They predicted that California would see a 1% increase in jobs -- modest but at least an increase -- and a much more robust 5.4% jump in personal income.

"The state's economic recovery will pick up as the year unfolds," the May revision concluded. "The economy will go into 2003 with good momentum."

Within a month, however, independent economic analyses were at odds with Davis' forecasts.

UCLA economists, who issue the most widely regarded California forecasts, predicted in late June that the number of jobs in California would grow by only 0.2% during 2002. Personal income was expected to increase just 1.2%.

Those predictions were available to Davis and the Legislature, but they did not take them into account. The budget was built using the administration's more optimistic assumptions.

While state lawmakers were locked in partisan bickering over whether to cut spending or increase taxes, California actually lost jobs, and personal income growth was sluggish.

The stock market, whose fortunes influence personal income and thus personal income tax receipts -- the state's primary source of revenue -- also headed downward.

Measured by the S&P 500 index, the market fell about 15% between May and Sept. 5, when Davis signed the budget. Again, no adjustments were made to the spending plan to account for that drop, even though it had serious implications for income tax projections.

The result was that the state budgeted \$40.5 billion from income taxes; officials said earlier this year they now expect only \$33.6 billion.

Susan Kennedy, former Cabinet secretary to Davis, defended the practice of updating economic and revenue forecasts only twice a year, in January and May.

"You do the best estimate you can," she said. Normally, the May figures hold up reasonably well, in part because the Legislature is supposed to pass a budget in June, so the numbers are still fresh. Last year, however, they missed that deadline, and the economy headed downward in the interim.

Kennedy said California's economy -- the fifth largest in the world -- is so big that "you can't update these numbers in real time." She acknowledged that at times of economic transition, "fairly significant changes" in the numbers are likely "once you lock in the May revise numbers."

As a result, administration officials knew by the time the budget was passed and signed into law that some of the state's revenue was going to be off target, Kennedy said.

More in Tax Refunds

Although some of the effects of the declining economy would have been difficult to anticipate precisely, in at least one area the state had ample warning that its estimates were far off. When individuals and businesses filed their tax returns, demands for refunds were far above the administration's estimates.

Refund filings naturally increase in lean years, as individuals and companies write off losses and personal income dips.

The quickest glance at monthly tax receipts would have highlighted the problems with their estimates. Each month of early 2002, refunds exceeded projections by tens of millions of dollars. In February alone, personal income tax refunds topped estimates by \$166 million.

But the governor and the Legislature made no move to account for that in the budget they were considering, even as actual refunds mounted through the year. From May through August, the period in which the Legislature was considering Davis' proposed budget, refunds outpaced the administration's estimates by \$242 million. Corporate tax refunds similarly were outpacing the amounts budgeted to pay for them.

By ignoring that trend, the governor and lawmakers under-budgeted the expense of paying those refunds. As it turned out, the state is now expected to pay \$2.4 billion more in individual and corporate refunds than it had budgeted.

That is roughly a fifth of this year's deficit that the state confronts.

The Final Gap

Despite overly optimistic projections of revenue that would never materialize and failure to account for refunds that were spiraling upward, state leaders in August were still faced with a budget proposal that remained out of balance. So they resorted to several gimmicks intended to bring the budget into artificial balance.

The first, widely derided at the time, was Davis' assumption that California would receive an additional \$1.1 billion from the federal government in 2002-03. That money, the governor said, would come in the form of increased support for spending associated with Medi-Cal, homeland security and illegal immigration.

With the federal government facing budget difficulties of its own, New York financial analysts and others warned against counting on that money. Still, elected leaders of both parties accepted a budget that depended on it.

Skeptics were proved right. No such increase came from Washington.

To win passage of the budget, Davis also agreed to a last-minute deal that counted on more than \$1 billion in savings from unspecified cuts in state operations and an early retirement program for state workers. The retirement program was intended to save the state money by encouraging thousands of employees to leave the government early.

But state departments were given little incentive to participate. For employees who accepted the early retirement offer, their departments were required to pay additional pension benefits plus accumulated vacation and sick leave.

In the end, 68 state workers applied for and received early retirement. Not only did the program fail to save money, it actually cost about \$100,000.

Kennedy, the governor's former Cabinet secretary, blamed the early retirement deal on Assembly Democrats, who she said sketched it out on a napkin in their haste to cut a deal. But the governor agreed to it, and Assembly Republican leader David Cox said last week that at the time the budget passed last summer, he believed Davis would offer the early retirement program to thousands of state employees.

"The reality is, they didn't offer it," he said. "It didn't materialize."

The state did find some state operations to cut outside the retirement program. But instead of achieving \$1 billion in savings, the cuts amounted to about \$320 million.

The Aftermath

When he signed the budget into law just after Labor Day, Davis credited the spending plan with taking "an important step in meeting the state's fiscal challenges." Others were less charitable.

Senate President Pro Tem John Burton (D-San Francisco), who voted for the plan, nonetheless described it as a "get-out-alive budget" and predicted that the state's financial problems would be severe this year.

Stephen Levy, director of the Center for Continuing Study of the California Economy, said Democrats and Republicans "put off the decisions" until after the November election.

"There was a bipartisan agreement and understanding that the budget solutions in September would not solve the problem," he said recently.

Wall Street was quick to weigh in with its doubts. When California sought to borrow \$12.5 billion to cover the state's cash needs in October, a month after the budget was signed, credit-rating agencies warned that the governor's assumptions about growth in tax revenue were "too robust."

The agencies responded by imposing a lower rating on \$3-billion worth of the state's short-term notes and served notice that the outlook for the state's overall credit rating was negative.

California Legislative Analyst Elizabeth Hill finally ended the fiction that the budget was balanced when, after the election, she announced that the state faced a deficit of at least \$6.1 billion in the current fiscal year.

Since then, the gap between the state's income and spending has only grown larger. Davis has proposed spending cuts to make up some of that difference, but the Legislature has yet to act.

Meanwhile, analysts in New York have continued to react negatively to the situation. In December, Standard & Poor's downgraded the state's credit rating to the same level as Louisiana's; Moody's followed suit this month.

In a conference call last month and in personal meetings in New York, state Finance Director Steve Peace sought to reassure Wall Street analysts and investors that the state is planning for all contingencies.

During the call, Howard Roth, the state's chief economist, was questioned about his latest economic forecast, which had swung from optimistic before the election to pessimistic since Davis was reelected.

Roth then acknowledged what had been known for months -- that the economic recovery stalled midway through last year and that the state actually lost jobs.

"The year ended," he said, "on sort of a weak note."

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