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Budget compromise remains elusive

Legislators divided over tax hikes, spending cuts

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July 21, 2008

SACRAMENTO – After seven years of deficits, lawmakers are talking about finding a way to reform a state budget that has been wallowing in borrowing and red ink for nearly all of this decade.

But they are miles apart. The political deadlock that created the deficits extends to reform: Republicans oppose tax increases, Democrats oppose spending cuts.

A suggestion by Republicans that they might agree to a tax increase in exchange for a spending limit and “rainy-day” reserve does not seem to be moving Democrats.

“We really need for them to say 'yes' to a spending cap, 'yes' to a 'rainy-day' fund, and then we can open up discussions on everything,” said Assembly Minority Leader Mike Villines, R-Clovis.

Villines said Republicans, who have signed a no-new-tax pledge, understand that Democratic acceptance of a spending limit would require a “significant compromise on our side,” such as ending some tax credits and exemptions.

Senate President Pro Tem Don Perata, D-Oakland, asked about trading a spending cap for a tax increase, said it depends on what kind of a cap.

“I don't think you can just have a cap out there and think you have solved the problem,” Perata said, adding that other issues must be addressed. “That's an illusion.”

The budget has been overdue since the fiscal year began July 1. The immediate problem for lawmakers is another big hole in the general fund budget.

Taxes are expected to yield \$94.5 billion, most of that – \$53.7 billion – from the income tax. Gov. Arnold Schwarzenegger's budget plan would spend \$102 billion.

Schwarzenegger would close the hole with \$5 billion in lottery-backed bonds and by counting \$2 billion in tax revenue from the first quarter of next fiscal year.

The Democratic plan spends \$106 billion, providing \$2.3 billion more for schools and \$1.5 billion more for health and welfare programs. It is based on a \$9.7 billion tax package, including a \$5.6 billion tax increase for upper-income earners.

For the past seven years, budgets have used temporary sources to close the budget gap, which cover only one year and allow the deficit to reopen in the following year.

The big temporary revenue source was a \$15 billion deficit bond, Proposition 57, approved by voters in March 2004. The last of the bonds, \$3 billion, were spent this year to shrink the current budget hole.

A classic budget accounting maneuver that provides revenue for only one year is the governor's proposal to switch to "accrual" accounting, allowing tax revenue from July-September 2009 to be counted in the fiscal year that ends in June 2009.

Another source of temporary revenue: Raiding funds that normally go to local government and transportation. By wide margins, voters approved measures in 2004 and 2006, both labeled Proposition 1A, to curb the raids.

The Legislature persuaded irate local governments and transportation groups to drop much tougher initiatives by placing its own measures on the ballot.

Some Republican legislators, using provisions in the softer Proposition 1As, are talking about getting a "loan" of \$2.5 billion that would be paid off in three years, alarming local governments and transportation groups.

Republican legislators also are talking about taking unspent funds from actor-director Rob Reiner's decade-old Proposition 10, a tobacco tax to aid early-childhood development.

Some have even talked about issuing bonds paid off by redevelopment agencies scheduled to expire. The agencies would give property-tax revenue in exchange for an extension and a looser definition of "blighted" property to make obtaining land through eminent domain easier.

Legislators in both parties say the governor's proposal to issue \$15 billion in bonds paid off by increased lottery sales might provide revenue in the future, but is not a good way to help balance the budget.

The plan to increase lottery sales, now about half of the per-capita average in 40 other state lotteries, would have to be approved by voters in November. The sales tax would be increased if voters rejected the lottery plan.

Although at odds on many things, legislators in both parties are calling for long-term budget reform.

The chronic deficits began when tax revenue soared during the high-tech boom around 2000. About \$12 billion in temporary revenue was spent on programs and tax cuts, leaving a budget hole when revenue returned to normal levels. It was an extreme example of the "boom-bust" cycle in recent decades.

Last August, a Perata letter to the governor and legislative leaders calling for creation of a budget revision panel went unheeded, overshadowed by legislative special sessions last fall on water and health care.

"There is no debate," Perata wrote. "The state budget is fatally broken. We can no longer limp along from year to year. It's time to fix the problem."

Perata, among other things, pointed to "autopilot" spending required by several ballot initiatives and the need to make a decision defining the "core responsibilities of state government" and how to pay for them.

A school-funding guarantee narrowly approved by voters two decades ago, Proposition 98, and zealously enforced by powerful school groups, gives schools about 40 percent of the state general

fund.

The measure would give schools about half of the tax increase proposed by Democrats. The increase would become part of the school-funding guarantee, automatically driving up spending in the future.

Schwarzenegger's proposal to use \$5 billion in lottery bonds to help balance the new budget, and \$10 billion in lottery bonds to build a "rainy-day" reserve, is flexible revenue not covered by Proposition 98.

Assembly Speaker Karen Bass, D-Los Angeles, who took the post in May, wants to appoint a bipartisan commission to recommend a "modernization" of a tax structure, creating a broader and more stable revenue stream.

Much of the revenue currently comes from income taxes paid by the wealthy, which makes big swings as the economy grows and slows. Bass acknowledged that the Democratic plan to raise taxes on the wealthy could increase the swings.

Bass said the current budget crisis must be solved. She originally planned to appoint the tax commission in June, but decided to wait until a new budget is enacted.

"You can't do both (a new budget and tax reform) at the same time, and you can't do it in a thoughtful manner," Bass said.

The spending limit proposed by Republican legislators is similar to the original version of the "Gann limit," named after Paul Gann, one of the co-authors of the landmark Proposition 13 property-tax cut passed 30 years ago.

Proposition 4, the "Spirit of Thirteen," limited state spending to the annual growth in population and inflation, like the new Republican plan, and it's still on the books.

The Gann limit was loosened in 1990 by Proposition 111, a gasoline-tax increase backed by business groups and then-Gov. George Deukmejian, a Republican, to aid highways and transit.

The Gann limit is now based on the annual growth in population and per-capita income. It is roughly \$12 billion above the current level of general fund spending, Republican legislative aides said.

Schwarzenegger is making a third attempt to get a spending limit. Democratic legislators rejected his proposal shortly after he took office in 2003. Voters rejected another proposal in 2005.

The governor's new plan, promoted across the state for months, would limit spending to the average revenue growth during the previous decade, currently around 5 percent.

"Look, I cut to the chase," Schwarzenegger said last week. "I know what the Democrats like, and I know what the Republicans like. So, I say let's meet somewhere in the middle. You know, the Republicans like a tight cap, and the Democrats don't like a cap."

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