Eighteen days into the new fiscal year, the state has no budget and there's no agreement in sight. It's no wonder that Californians, many struggling with their own financial woes, are frustrated with their legislators.

Gov. Arnold Schwarzenegger threatened to put the Legislature's four leaders in a room and keep them there until there's a budget that two-thirds of the Legislature can support. They met again Wednesday and Thursday, though nothing significant was accomplished.

Democrats insist on some tax increases and the Republicans say absolutely not. That intransigent position means the $15 billion budget deficit would have to be resolved entirely through spending cuts if you take the GOP position. But the Republicans haven't released specifics on what those spending cuts might be.

Sen. Dave Cogdill of Modesto, the Senate Minority Leader, told the Modesto Bee that Republicans don't want to negotiate in the media. He said they have offered $10 billion in cuts in budget talks.

Californians need to hear the details. Some are likely reasonable, affecting programs the state simply can't afford in a tough economy. It would take a lot of such small cuts to add up to the billions needed, but citizens would at least know that legislative leaders are making progress.

Our position is simple: financial problems of this size will have to be resolved through a combination of tax and fee increases and spending cuts. The cuts inevitably will hit crucial areas -- schools, prisons and health care programs. That's where most money is spent, so that's where the reductions must be found.

Cogdill wants long-term budget reform, not just to reach a one-year budget deal. We agree. A bipartisan group called California Forward has put together thoughtful ideas in a paper called "Curing Deficits and Creating Value." It's available on the Web site www.caforward.org.

Cogdill says that if reforms had been enacted five years ago, in plentiful times, the state wouldn't be in the situation it is today. That's true, but offers only useful lessons. The focus must be on fixing the budget now.

Democrats who control the Senate-Assembly conference committee produced their version of the budget, with $8 billion in tax increases. It contains flaws, but at least it's a plan. If the Republicans would go public with their spending cuts, citizens would have a better sense of the trade-offs necessary to resolve the budget problem.

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Legislature considers raiding voter-approved funds

Money earmarked for transportation and government services would help close massive budget shortfall.

Schwarzenegger says it isn’t a good idea but doesn't rule out signing off on it.

By Evan Halper
Los Angeles Times Staff Writer

July 18, 2008

SACRAMENTO — Legislative leaders are drafting a complicated scheme to help close the state's massive deficit by raiding funds voters have set aside for transportation and local government services, Gov. Arnold Schwarzenegger said Thursday, adding that it probably would force a state sales tax hike.

"It is not a good idea," the governor said in an interview with The Times. But Schwarzenegger, anxious to get a budget passed before the state experiences a cash crisis, did not rule out signing off on such a plan.

During the half-hour interview in his office, the governor offered a broad outline of the proposal being discussed in closed-door budget negotiations. Schwarzenegger, who seemed exasperated by his inability to fix California's fiscal dysfunction five years into his governorship, cited the borrowing plans to bolster his point that the state's budget system was in need of reform.

The proposal is being considered as part of a possible compromise between Democrats seeking to close the deficit with $5.6 billion in income tax hikes on the rich and Republicans vowing to block any new taxes.

The legislative plan would balance the state budget with the help of $1.1 billion voters set aside for transportation projects and at least $1.4 billion earmarked for local governments under Proposition 1A, which was approved in 2004, Schwarzenegger said. State law requires that the money be paid back -- at a steep interest rate -- in three years.

In order to ensure that the money is repaid, "I literally would have to guarantee that with a sales tax or something," Schwarzenegger said. "Where [else] do we get the revenues that someone can be saying so freely we can pay back this $2.5 billion we are borrowing?"

Officials involved in the confidential budget negotiations, who agreed to speak on condition of anonymity, said lawmakers also were looking to borrow $200 million voters set aside for early childhood education programs through 1998's Proposition 10.

Local officials and advocates for the programs expressed alarm at the proposal to raid their funds. They accused legislative leaders of ignoring the will of voters, who approved the measures to prevent the state from touching the money in question.

"The money they would take is going to fund a huge amount of projects," said Jim Earp, executive director of the California Alliance for Jobs, a construction trades group. "It would be a complete violation of the spirit of Proposition 1A."

Earp said transportation advocates were mobilizing a campaign against the plan. He said direct mail would urge lawmakers to vote against it if it is included in the final budget deal.

In Los Angeles County, the proposal would force further cuts in healthcare and human services, and probably affect other programs, said county Chief Executive Officer William T Fujioka. He said the county would lose as much as $145 million this year.

"The human and social impact would be significant," he said.

Schwarzenegger expressed frustration that California may once again return to borrowing. He argued that if the state were to impose some spending restraints -- or at least require lawmakers to build substantial rainy-day funds -- the perpetual budget crises would stop.

"It is a self-inflicted situation we are in," Schwarzenegger said. "We know what the problem is, and we know this is the only way it can be fixed, but we are unwilling to do it."
For the third time this year, the governor is trying to make changes in the state Constitution that would require that money be put aside in good economic times. His first attempt, in 2004, was watered down by the Legislature, ultimately resulting in a weak reserve that was quickly wiped out when the state's revenue began to slow. That was followed by a ballot proposal that Democrats and labor groups warned would strangle government; it was defeated by voters in 2005.

"There was $100 million spent against it" and other unsuccessful ballot measures Schwarzenegger championed that year, he said, "because God forbid we should fix something."

Democrats say it is the governor who is exacerbating the state's financial problems, by refusing to recognize that California needs more revenue to provide the services polls show voters want. Schwarzenegger's first action in office was to cut vehicle license fees, a move that is now costing the state as much as $6 billion. Democrats say the state needs that money, and that imposing spending restraints without replacing it would ultimately reduce government services substantially.

The standoff has allowed California's fiscal problems to grow under the governor's watch, even as other states have implemented reforms. In a recent ranking by the nonprofit Pew Center on the States, California's budget system received a D-plus, the lowest grade given any state.

Schwarzenegger's role in the budget process has been limited this year. Lawmakers complain he is often out of state boosting his national profile.

But the governor says he has met his deadlines for presenting budget plans, and that his attempts to get lawmakers to work on the problem throughout the year were rebuffed.

Schwarzenegger twice during the interview mentioned how Senate Leader Don Perata publicly implied that the governor should butt out of budget deliberations, saying that if he wanted to be involved, he should run for the Legislature.

"I kept saying all spring, 'Guys, don't wait until the last minute,' " Schwarzenegger said. "Then Perata makes his statement that 'He shouldn't be telling us what to do.' We don't have the luxury to improvise this year. We are running out of cash."

The delay in dealing with the budget problem, the governor said, ultimately spilled over into other business at the Capitol, making it impossible to achieve anything of substance.

Schwarzenegger said he ranks the bills the Legislature sends to his desk into weight categories, a nod to his days as a bodybuilder. This year, he said, there is "very rarely a heavyweight bill."

"We can't move the state forward because everyone gets frozen," he said.

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State legislators consider increasing income taxes on the wealthy

California's tax rate is the nation's highest, but budget woes are prompting proposals to raise it further. Tax foes say it could backfire by driving businesses and top earners out of the state.

By Evan Halper
Los Angeles Times Staff Writer

July 18, 2008

SACRAMENTO -- California has long had a reputation for soaking the rich, claiming a particularly large slice of their earnings to feed its growing government. Now, legislative Democrats want to push it further.

Their plan to balance the state budget would raise the wealthiest Californians' income taxes -- already the highest in the nation -- to a level not seen anywhere in the country in years. After years of income taxes steadily dropping elsewhere, California would raise the effective rate on those earning at least $1 million to 12%, more than twice the rate in most other states that have income taxes.

Although legislative leaders are weighing a plan to balance the budget in part by raiding transportation funds and local government accounts, many Democrats are still rallying around an income-tax increase as the best way to bring the budget into balance over the long term.

Economists and money managers, though, are wondering whether California would be returning to this well one time too many. There is, they say, a point at which the cash infusion is outweighed by damage done to the economy: Entrepreneurs get driven away. Profits get stowed in tax shelters. Companies shelve plans for expansion.

"The more a tax sticks out like a sore thumb, the more taxpayers will look for ways to avoid it," said Robert Ward, deputy director of the Nelson A. Rockefeller Institute of Government in Albany, N.Y. California's income tax on its highest earners "would be a significantly higher rate than in any other state." Rhode Island's is the next highest, at 9.9%.

Robert Brown is well aware of that. The 72-year-old small-business owner from Thousand Oaks isn't a million-dollar earner, but his income is in the high six figures, and the state tax on it would jump from 9.3% to 11% under the Democratic plan. He's considering bolting.

"These people have no concept that when you raise taxes, you drive people away," he said. "Quite a number of my good friends have moved -- to New Mexico, to Arizona, to North Carolina. We are thinking about doing the same."

Proponents of tax hikes, though, say there is no evidence that meaningful numbers of high earners follow through on threats to leave. The number of wealthy Californians continued to swell after the last tax hike targeted at the rich, a 1% surcharge on income above $1 million that was approved by voters in 2004, according to the California Budget Project, a think tank that advocates for low-income Californians. And a study by the Public Policy Institute of California concluded that the state's job growth typically keeps pace with the national average.

People need not move away to avoid a tax increase. Those who handle money for the wealthy are already working on strategies.

"There are a lot of legitimate alternatives," said Jeff Fishman, a Century City money manager for the wealthy.

The options are as simple as giving a business an out-of-state address or as complex as setting up a pension fund for oneself with tax-free contributions. Socking away money in tax-free bonds is another option.

Nicholas Stonnington, a money manager in Los Angeles, said Californians could establish residence elsewhere just before they cash in a stock windfall or make millions on the sale of a business. "I know of people who have moved or are planning to move based on significant transactions they expect to have," he said. "People come up with ways to avoid paying taxes they view as excessive or unfair."

Democrats defend the tax-hike idea, saying the alternative would be thousands of teacher layoffs, hundreds of thousands...
of children and elderly Californians going without healthcare, cuts in public safety and other steep reductions in
government services. Public opinion surveys show Californians don't want those cuts.

Moreover, supporters argue, the increases would echo a move made under Republican Gov. Pete Wilson during the
budget crisis of the 1990s. The rates being proposed now -- minus the 1% surcharge on top earners -- temporarily went
into effect in 1991, they say.

Senate Budget Committee Chairwoman Denise Moreno Ducheny (D-San Diego) described the proposal as "just rolling
back tax cuts that have been made since 1997."

"The only way to get ourselves back from the cliff is to acknowledge the need for all of us as a community to pay for those
things we want done," she said.

But the 1991 example cuts both ways. Much of the money the state was expecting to generate from that tax hike didn't
materialize. Projections showed it would bring in $1.2 billion. Collections fell hundreds of millions of dollars short. To this
day, Democrats and Republicans in Sacramento argue about whether that shortfall resulted from the rich moving their
money elsewhere or from broader economic issues -- the state was entering a major recession at the time.

Some economists warn the state not to bank on the $5.6 billion that tax officials project can be raised with this year's
proposed hike.

"You sometimes get a lot less than you expect," said Bill Fox, director of the Center for Business and Economic Research
at the University of Tennessee and an expert on state taxation.

Denise Bustamante, a tax director at Deloitte Tax LLC, said she doubted an increase would prompt many wealthy
Californians to move. "But it will make businesses thinking of coming here rethink it," she said.

Small businesses typically file their taxes under the personal income tax rules instead of paying the corporate tax.
According to the California Taxpayers' Assn., that means half the state's businesses would be affected by the proposed
hike.

The Small Business and Entrepreneurship Council, a national trade group, and the Tax Foundation, a nonpartisan think
tank based in Washington, D.C., say the state's tax system is among the least business-friendly in the country. Both
groups ranked California in the bottom four. Only New Jersey fared worse in both studies.

Patrick Fleenor, chief economist at the foundation, said many companies had been willing to endure tough circumstances
for the privilege of doing business in California.

"But what is often missed is the firm that would have popped up in L.A. but is instead popping up outside Las Vegas," he
said. "People on the cusp of moving to California or leaving California would certainly be affected by this."

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