

Cal-Tax Digest

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Tax Issues



Wilson's Eight Years: From Fiscal Crisis to Record Tax Cut

By Ron Roach

Taking office in January 1991, Pete Wilson found himself at the helm of a state with a budget deficit that exceeded the total budgets of many states. Dealing with a Legislature controlled by Democratic majorities, the Republican governor sought spending cuts and soon recognized that whole departments could be eliminated without solving the problem. More revenue was necessary.

Pragmatically, the budget-balancing act had to include equal measures of spending reductions and higher revenues.

Governor Wilson's "preventive government" fiscal plans that drew so much bipartisan praise in his first State-of-the-State address soon had to be put on hold. The Golden State, hammered by defense contract cutbacks at the end of the Cold War and a worsening economy, was seen by national publications as losing its glitter. The business climate was hurting.

An anti-business attitude in the Legislature, not so apparent in the high-rolling 1970s and 1980s, began to take its toll. Competitor states touted their friendlier tax and regulatory systems as they recruited California companies. A veteran California legislator, John Vasconcellos, candidly acknowledged that the Legislature for too long had ignored the needs of business.



Governor Pete Wilson

In time, the 1990s would see a more responsive Legislature when dealing with glaring needs to make California more competitive for attracting businesses and jobs. The needs of businesses had champions on both sides of the political aisle.

But those early years of this decade were hard times, as many corporations cut back, postponed expansions or moved away. And there was a steady dose of natural catastrophes - fires, earthquakes, floods - and a devastating riot in Los Angeles. For some it seemed California bordered on being ungovernable. Pundits even wrote that Democrat Dianne Feinstein was the real *winner* of the governor's race in 1990 because she *lost* and did not have to deal with the state's fiscal mess. (In one of the all-time political ironies, Ms. Feinstein in 1992 was elected to the comfortable U.S. Senate seat that Pete Wilson gave up to run for governor. And she refused to give it up to run for governor in 1998.)

Pete Wilson persevered. He signed legislation raising taxes a record \$7.3 billion, including temporary tax brackets producing more income taxes from the wealthy. A similar amount of spending reductions was used to overcome what was by far the largest budget deficit in California history, \$14.3 billion.

The tax increase did not run smoothly. There was immediate criticism of the provision that slapped the sales tax on candy and snacks, and it was repealed by voters in 1992. There were political attacks from extremes on both sides, those who were totally against any tax increase and those who wanted even higher taxes. The state budget deadlock ran more than two months into the fiscal year.

After holding the line against tax increases in 1992, the Wilson Administration and the Legislature embarked on a run of six years during which tax relief was a major topic. Each year produced noteworthy tax relief except 1995, when the governor vetoed a Democratic power play.

For the California economy, it was a return to good times. A major threat to the recovery was rejected by voters in the defeat of Proposition 167 on the November 1992 ballot. This scheme, backed by public employee unions, sought to increase business taxes by billions of dollars.

Meanwhile, enactment of major tax reform legislation was in the wings.

Unitary Reform. In 1993, the Legislature passed SB 671 (Alquist), and Governor Wilson called it the most sweeping tax reform since 1978's Proposition 13. It included historic unitary reform for the way multinational companies are taxed by California, legislation that may have prevented an international incident as Great Britain threatened retaliation against U.S. firms operating in England.

MIC. This package also included long-sought manufacturers' investment tax credit (MIC) as California policy makers zeroed in on a major California deficiency that hurt its ability to compete with other states for manufacturers and jobs. The governor said tax incentives approved in 1993 were equal to a 10 percent reduction in state business taxes.

Sales Tax Hike. There was a tax increase in 1993 when voters approved Proposition 172 at a special election called by the governor. Instead of allowing the expiration of a one-half cent sales tax levied to help pick up the pieces of the Loma Prieta earthquake, the governor proposed that the tax be made permanent with the money dedicated to local public safety programs. It was part of the governor's plan to provide replacement revenues for local governments after he championed the shift of their property tax revenues to schools.

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This multi-billion-dollar revenue shift helped balance the state budget by taking local dollars for schools instead of state general fund money. But it drew criticism, including opposition from the business community. It was a rare break in the linkage of business support for Governor Wilson's fiscal agenda. Businesses generally supported Proposition 172, however.

Partisan Fights and Vetoes. In 1994, Governor Wilson proposed tax credits for small businesses that create jobs and a 19 percent reduction in personal income taxes for middle-class taxpayers. When the Legislature ditched his proposals, as Democrat leaders refused to go for major tax relief in back-to-back years, the governor's vetoes carried the day for taxpayer interests.

For example, the governor rejected bills to allow benefit assessments for libraries without first gaining voter approval and

allow school districts to impose parcel taxes without two-thirds voter approval. The Legislature also defeated a bill opposed by business to create a tax incentive allocation committee.

In December 1994, with revenues flowing in from a rebounding economy, the Governor's Council of Economic Advisors, led by former U.S. Secretary of State George Shultz, unveiled a glowing economic forecast in a report that called for a 15 percent reduction in personal and business income taxes over three years.

Political Gamesmanship. Tax-cut fever was pushed aside by political power struggles in 1995. Governor Wilson proposed a 15 percent reduction over three years in personal income and corporate taxes in his state-of-the-state address. The proposal was approved by an Assembly which, for the first time in 20 years, had a Republican majority.

But the Senate was controlled by Democrats who killed the governor's proposal. Instead, the Senate approved a tax-cut, tax-increase bill engineered by Senate President Pro Tem Bill Lockyer to attract just enough Republican Assembly votes for passage. Governor Wilson vetoed it as a "cynical attempt to leverage tax increases on the back of worthy tax reforms." Senator Lockyer expressed outrage, saying the measure was carefully targeted tax relief for small businesses and growth industries, providing two dollars in tax cuts for every dollar of increase.

One newspaper columnist said the Lockyer-led effort was a "diabolical" plot designed by the governor's enemies to put him in a "box" and either sign the bill or veto tax relief directed at specific corporations. CEOs of companies that would benefit from the deal sought the governor's approval.

Property Tax Reform. While there was no bottom-line dollar figure for tax relief in the measure, the Legislature passed a bill sponsored by Cal-Tax, whose president, Larry McCarthy, said was the most significant property tax administration reform in three decades. Skillfully authored by Senator Ken Maddy, SB 657, among other things, provided guidance for assessors in the treatment of intangible business assets. It was designed to prevent assessors from treating the property tax as an income tax by basing assessments on the success and income of a company.

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Corporate Tax Cut. In 1996, Governor Wilson succeeded in getting the first third of his proposed 15 percent reduction in the corporate income tax rate. The governor also agreed to 25 separate tax-cutting provisions in a Lockyer-authored bill that passed the Legislature with bipartisan negotiation and support, unlike the 1995 experience that resulted in a veto.

PIT Reduction. Now it was personal income taxpayers' turn for relief, but it didn't come until the 11th hour of the legislative session. It was the largest permanent personal income tax (PIT) reduction since 1943, when then-Governor Earl Warren presided over a 35 percent cut in the income tax.

The 1997 package, amounting to \$608 million in tax relief during the first three years, included an increase in the dependent credit and an exemption from tax for the first \$500,000 gain on the sale of a home, expanded research and development tax credits and broadened tax relief for smaller companies and expanded individual retirement accounts.

Record Tax Cut. Vowing to leave office as a net tax-cutter over eight years, Governor Wilson in 1998 claimed that achievement when he signed the largest tax cut ever passed by the California Legislature and signed by the governor. It would amount to \$3.6 billion over the next five years, including an immediate 25 percent cut in the vehicle license fee, or car tax, an increase in the dependent tax credit and a restored tax credit for renters.

The legislation would eventually reduce the car tax by two-thirds if the economy continues to grow and revenues reach certain thresholds. However, abandoned during the session was the governor's proposal to build on the 5 percent corporate tax rate reduction that passed in 1996.

A major achievement in 1998 was enactment of California's Internet Tax Freedom Act, which restricts state and local taxation of electronic commerce.

The last eight years included some of the leanest fiscal times since the Great Depression, but also some of the fattest. Governor Wilson said he saved California taxpayers from automatic-spending budgets with his vetoes, holding the line on state employee salaries and keeping welfare benefits in check. He vetoed more than \$3.8 billion from eight budget bills. Still, after running an extremely tight ship with diminished revenues

in the recession, spending also has grown significantly, in excess of 7.9 percent annually over the past four years.

Governor Wilson said he is leaving California in better financial condition than when he took office, and that is true (a 2 percent budget reserve). The next governor should not be under pressure to increase taxes as soon as he walks in the door. Ronald Reagan and George Deukmejian inherited major budget headaches, and so did Pete Wilson. Until now, Jerry Brown in January 1975 was the only California governor in three decades to begin a first term when the state was in good fiscal health.

Perhaps California's new governor, Gray Davis, may get a few years respite before he calls for heavy-duty aspirin.

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