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Schwarzenegger to offer budget peace plan

By Jim Christie

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SAN FRANCISCO (Reuters) - When California Gov. Arnold Schwarzenegger presents his revised state budget on Friday, he will offer to pay down state debt and boost school spending, according to a state official.

With the state's revenues coming in at a better-than-expected pace, Schwarzenegger can offer an election-year peace pact with the state's Democrat-led legislature, analysts said on Wednesday.

At the same time, Schwarzenegger will rally fellow Republicans when he proposes the state use its revenue surge to trim its debt when he presents his "May revise" budget plan.

"The governor is going to propose even more money for education," state Finance Department spokesman H.D. Palmer told Reuters on Tuesday. "The two major priorities you'll see in the May revision are paying down debt and providing more resources for education."

That could frame unusually civil budget talks with lawmakers, Steven Frates, of the Rose Institute of State and Local Government at Claremont McKenna College, said on Wednesday.

"If he does not do this it would probably lead to a very contentious budget period," Frates said.

May revise plans use data from tax filings to build on budget proposals California governors publish in January. They mark the official start of budget talks with lawmakers.

With strong tax collections, Schwarzenegger will be able to urge increased school spending that Democrats want and paying debt in a nod to tightfisted Republicans, moves that may help his bid for re-election in November.

Democrats will contest it, with either state Treasurer Phil Angelides or state Controller Steve Westly as their standard bearer.

"He wants to play the middle ... He doesn't want to run into a budget season that goes late into the summer," PIMCO credit analyst David Blair said of Schwarzenegger.

The governor, attempting to recover popular support after voters rejected his ballot measures in a special election he called last year, wants to avoid "business as usual" with lawmakers.

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"Schwarzenegger knows he is in the spotlight and he knows everything he does will be magnified," said Robin Rappaport, a municipal bond strategist with Payden & Rygel.

The celebrity Republican governor and the legislature were sharply at odds over previous budgets because he aimed to hold down spending and ruled out tax increases to close shortfalls.

Democrats charged he was shortchanging vital programs such as education -- teachers are a powerful force in the state Democratic party -- and their sparring led to often nasty and drawn-out budget talks, adding to Wall Street's anxiety.

Wall Street is reluctant to raise California's credit rating because state spending persistently exceeds revenues. It fears partisan sniping will escalate into gridlock.

Improved revenues suggest sniping after Friday may be muted. A surge in capital gains from big profits from home sales, a strong stock market and, according to some analysts, Web-search leader Google Inc.'s stock options being exercised, give California at least \$3 billion more than expected in the \$125.6 billion budget plan Schwarzenegger unveiled in January.

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