# AGENDA
## ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION

## PART II

### Assemblymember Rudy Bermudez, Chair

**TUESDAY, MAY 16, 2006, 1:30 PM**
**STATE CAPITOL, ROOM 447**

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## CONSENT CALENDAR



## ITEMS TO BE HEARD

# ITEMS ON CONSENT

## CONTROL SECTION 12.00 STATE APPROPRIATIONS LIMIT

This annual Budget Control Section establishes the amount of the State Appropriations Limit for the fiscal year of the budget. Because the final calculation of the limit for 2006-07 must be consistent with the final budget adopted in conference, action must be taken to place this section in conference.

**Action:** Reduce the amount by $1 million to place the section in conference (the Senate will approve as budgeted).

2. Adopt Trailer Bill Language proposed by the LAO to make a technical correction to Government Code Section 16418, requires the Legislative Analyst and the Director of Finance to send a joint letter to the Controller telling him/her that there is enough room under the state's spending limit to transfer any year-end unencumbered funds into the special fund for economic uncertainties. The technical correction eliminates a "double counting" problem with the calculation. The correction would not have any impact on the spending limit calculations themselves.

## CONTROL SECTION 35.50 GENERAL FUND REVENUE ESTIMATE

This annual Budget Control Section establishes the General Fund revenue estimate on which the budget is based for the purposes of the balanced-budget requirement of Proposition 58. Because the final revenue estimate for 2006-07 must be consistent with the final budget adopted in Conference, action must be taken to place this section in conference.

**Action:** Reduce the amount by $1 million to place the section in conference (the Senate will approve as budgeted).

# ITEMS TO BE HEARD

## ITEM 0840 STATE CONTROLLER

The subcommittee last heard the budget of the State Controller's Office (SCO) at its April 18th hearing.

### ISSUE 1: 21ST CENTURY PROJECT—APRIL FINANCE LETTER

The 21st Century Project is a multi-year project to replace the state's existing Human Resource Management System (HRMS)--employment history, payroll, leave accounting, and position control systems. The new HRMS will also include a statewide time and attendance capability, greatly enhancing the Controller, Administration, and Legislature's fiscal oversight abilities. For example, it is expected that the system will eventually capture actual salary savings at each department, replacing the arbitrary five percent standard commonly used statewide today. The new system also will do a much better job of accounting for personal services costs by funding source. Moreover, the existing systems are becoming obsolete and difficult to maintain, so that replacement would be needed even without the increased functionality.

As revised by an April DOF letter, the SCO requests an $35.1 million ($17.7 million General Fund) and 77.6 two-year limited-term positions in 2006-07 to implement the design, development, and initial rollout phases of the HRMS. This request amends the Governor's Budget proposal by increasing the number of positions from 46.5 to 77.6 and decreasing General Fund expenditures from $20.1 million to $17.7 million to reflect a reduction in vendor staffing. Compared with the January budget, the revised proposal decreases General Fund costs by $2.4 million in 2006-07.

Although 2006-07 costs have decreased, total costs over the life of the project and the General Fund share have increased somewhat. Based on the contract to be signed, the total cost of the project will be $138.4 million, $60.9 million of which will be General Fund. This new total is $6.3 million over the previously assumed cost, identified in the feasibility study report, and General Fund costs have increased by $9.3 million to $60.9 million. The project was first funded in 2003-04 and is expected to be completed in 2009-10.

## ISSUE 2: SCO REQUEST FOR DELETION OF RESTRICTIONS ON OUTREACH FOR UNCLAIMED PROPERTY AND PERFORMANCE AUDITS

The SCO is requesting deletion of two Budget Bill language provisions that have been included in the SCO's main budget appropriation (Item 0840-001-0001) for a number of years.

**Outreach to Owners of Unclaimed Property**

The SCO requests deletion of Provision 5(b), which limits spending for general public outreach about the unclaimed property program to $15,000. The existing provision also limits the $15,000 to outreach that is part of an existing activity organized by the Controller for other purposes. The SCO argues that this provision inhibits them from conducting outreach to reunite owners of unclaimed property with their lost assets.

> 5. (a) Notwithstanding subdivision (b) of Section 1531 of the Code of Civil Procedure, the Controller may publish notice in any manner that the Controller determines reasonable, provided that (1) none of the moneys used for this purpose is redirected from funding for the Controller's audit activities, (2) no photograph is used in the publication of notice, and (3) no elected official's name is used in the publication of notice.
>
> **(b) No funds appropriated in this act may be expended by the Controller to provide general information to the public, other than holders (as defined in subdivision (e) of Section 1501 of the Code of Civil Procedure) of unclaimed property, concerning the unclaimed property program or possible existence of unclaimed property held by the Controller's office, except for informational announcements to the news media, through the exchange of information on electronic bulletin boards, or no more than $15,000 per year to inform the public about this program in activities already organized by the Controller for other purposes. This restriction does not apply to sending individual notices to property owners (as required in subdivision (d) of Section 1531 of the Code of Civil Procedure).**

The SCO also requests deletion of Provision 8, which prohibits the Controller from using funds appropriated in the budget to conduct performance audits (as opposed to fiscal audits) without express statutory authorization.

> **8. The funds appropriated to the Controller in this item may not be expended for any performance review or performance audit except pursuant to specific statutory authority. It is the intent of the Legislature that audits conducted by the Controller, or under the direction of the Controller, shall be fiscal audits that focus on claims and disbursements, as provided for in Section 12410 of the Government Code. Any report, audit, analysis, or evaluation issued by the Controller for the 2006–07 fiscal year shall cite the specific statutory or constitutional provision authorizing the preparation and release of the report, audit, analysis, or evaluation.**

The SCO argues that its fiscal audits often uncover performance issues and proposes to adopt a target of 20-to-one return for performance audits.

## COMMENTS

**Unclaimed Property Outreach.** Deleting the $15,000 limitation raises the issue of how much of the SCO's budget would be diverted to an outreach effort. The subcommittee may wish to consider increasing the limit to a more meaningful amount, such as $50,000.

**Performance Audits.** Other entities, such as the Bureau of State Audits, undertake performance audits. If the SCO believes that it has appropriate and cost-effective performance audit opportunities, then it would be advisable for the office to develop a budget proposal for the 2007-08 budget identifying the types of audits it is planning and the resources needed.

## ITEM 0860 STATE BOARD OF EQAULIZATION

### ISSUE 1: SALES AND USE TAX ADMINISTRATION COST ALLOCATION

At its April 5th hearing, the subcommittee directed LAO to prepare Trailer Bill Language to implement their recommendation for a new methodology for allocation of sales and use tax (SUT) administrative costs between the state General Fund, the local Bradley-Burns tax and the Special Taxing Jurisdictions (STJs) that impose voter-approved additional SUT rates. LAO has prepared the language.

**Background.** As discussed on April 5th, the Legislature directed the State Board of Equalization (BOE) in the 2004-05 Budget to evaluate and report on alternative methodologies to allocate the costs of administering and enforcing the state and local SUTs. The current cost-allocation system is highly complex and was developed in the early 1990s when there were far fewer STJs—geographic areas with additional voter-approved SUT rates. The BOE prepared that report in consultation with the Department of Finance, the Legislative Analyst's Office (LAO), and representatives of local sales tax jurisdictions. Based on its review and analysis of the BOE report, LAO now recommends adoption of one of the alternative cost-allocation methodologies identified in the report. According to LAO, this methodology does the best job of meeting the following criteria:

- Relatively straightforward to determine.
- Methodology can be easily explained.
- Reasonably related to each tax component's cost.
- Can readily incorporate additional special tax jurisdictions.

**Fiscal Effect of New Methodology.** BOE estimates that use of the new methodology would reduce General Fund costs by $5.7 million in 2006-07. Costs allocated to the uniform local SUT (the Bradley-Burns tax and uniform county transportation tax) would increase by $14.5 million, while the costs allocated to local STJs would decrease by $8.8 million. To place these cost shifts in context, state and local SUT revenues in 2006-07 will total about $37 billion.

**<u>Excessive Property Tax Shift for the "Triple Flip"</u>**

During discussions about the allocation of SUT administrative costs, it also came to light that the state has been shifting an excessive amount of property tax revenue from schools to local governments under the "Triple Flip," resulting in an excess General Fund cost of approximately $10 million annually.

**The Triple Flip.** Under the "Triple Flip," the state imposed a new temporary quarter-cent SUT dedicated to repayment of the Economic Recovery Bonds. The state also suspended a quarter-cent of the local Bradley-Burns tax in order to keep the total rate constant. In the second leg of the Triple Flip, Local governments are kept whole by transfers of property tax revenue to cities and counties from schools. In the third leg, the state General Fund makes schools whole by replacing the amount shifted property tax revenue. The net result is that the General Fund bears the cost of repayment of the ERBs in the form of higher payments to schools.

**Excess Shift.** State Law (Revenue and Taxation Code Section 97.68) requires the Director of Finance to provide the county auditors with annual estimates of the local Bradley-Burns revenue loss. The county auditors then shift an equal amount of property tax revenue from the schools to the cities and counties. The directors estimate must be based on the "actual amount of sales and use tax revenues transmitted" to cities and counties in the prior year under the Bradley-Burns tax (adjusted to a one-quarter-cent basis) plus an estimated growth factor. There is also a settle-up adjustment each year to reconcile the prior-year estimate with the actual revenue loss. The intent of this process is to replace the local Bradley-Burns revenue loss with a precisely equal amount of property tax revenue.

However, the Bradley-Burns revenue loss estimates forwarded by BOE to the Department of Finance (DOF) have been based on Bradley-Burns revenue *collections*, rather than revenue *transmittals*. The difference is that the amounts local governments actually receive are less a deduction for administrative costs. The Department of Finance has forwarded these amounts to county auditors without correcting them. As a result, cities and counties have received more property tax revenue under the Triple Flip than their actual loss of sales and use tax revenue. The difference is about $10 million annually.

**$20 Million at Stake for 2006-07 Budget.** DOF should take corrective action to realize General Fund savings of $20 million for the 2006-07 Budget. This would be accomplished by correcting the 2005-06 allocation in the 2006-07 settle-up and using the correct methodology for the 2006-07 estimate. There also would be ongoing annual General Fund savings in excess of $10 million until the ERBs are paid off.

## COMMENTS

**No Effect on Realignment or Local Public Safety Revenues.** Under existing law, the half-cent SUTs imposed for Realignment (the Local Revenue Fund) and for local public safety (the Local Public Safety Fund) are not assessed for administrative costs. Instead, those costs are born primarily by the state General Fund. Adoption of the new cost-allocation methodology would *not* change this.

**Legislative Counsel Opinion on Triple Flip.** The issue here is not whether local governments should be "charged" for collecting the quarter-cent tax–the state is actually paying this portion of BOE's administrative costs while the Triple-Flip is in place. The question is whether the law requires replacement of the suspended local revenues that cities and counties actually would have received (the net revenue) or whether local governments receive a "bonus" from the state. At staff's request, Legislative Counsel has reviewed the relevant statutes and opined that they require the replacement of the *net* revenue loss.

## ISSUE 2: ELECTRONIC FILING

On April 5th, the subcommittee discussed BOE's plans to expand electronic tax return filing and payment. In particular, BOE indicated that it did not expect to extend e-filing to businesses with multiple locations (most larger retailers) until 2008. The Subcommittee requested BOE to provide a more specific timetable for expansion of e-filing along with costs and savings and an evaluation of making e-filing mandatory.

BOE responded with a report to the subcommittee (*Electronic Services, Strategic Vision and Initiatives)* in April.

## COMMENTS

The BOE report raises a number of questions.

1. The percentage of revenue collected through Electronic Funds Transfer (EFT) actually is *declining* from a peak of 78 percent in 2002-03 to an estimated 69 percent in 2005-06. This is occurring despite the fact that the mandatory EFT threshold recently was lowered from $20,000 per month to $10,000 per month. BOE should explain why this is happening.

2. The BOE report indicates it intends to submit a feasibility study report (FSR) for an expansion of E-filing (in addition to EFT payment) to multi-location retailers, prepayment accounts and other major SUT taxpayers. Implementation would occur 12 to 18 months after approval of the FSR (and presumably budget approval). This schedule probably would put implementation into 2008-09. The BOE should address what proportion of SUT taxpayers currently can e-file and the number who actually do e-file, and also explain why large-scale implementation of SUT e-filing is taking so long.

## ISSUE 3: RETAIL LICENSING ENFORCEMENT

The Governor's budget proposes $1.6 million ($1.1 million General Fund) and 14.5 positions (13.8 PYs, 2-year limited term) for a BOE "pilot program" to identify and register businesses that fail to pay sales and use taxes on the goods and services these businesses provide. The board estimates that these enforcement efforts will generate $12.6 million in additional sales and use tax revenues in 2006-07 ($7.9 million General Fund).

## COMMENTS

- **More Resources Would Yield More Revenue.** The $12.6 million gain is only a small portion of the $300-million annual tax loss that the BOE estimates from unregistered businesses. Clearly, 13.8 PYs is a very small number to canvass businesses in California and to take enforcement actions against violators. Detecting and correcting one-third of the estimated unlicensed retailers in California would require 118 positions, according to the board. More resources could produce more revenue at a high benefit-to-cost ratio. For example, the board estimates that annual revenue gain could be increased to $25 million ($15.7 million General Fund) by adding 33 positions, instead of the 14.5 positions requested. The board estimates that the total cost of this alternative would be $3.5 million ($2.4 million General Fund). The augmentation would have a 6:1 benefit-to-cost ratio.

- **Why Another Pilot?** The current proposal is based on the results of a test sweep of over 700 retail locations. It is not clear why a second pilot is needed.

## ISSUE 4: ABUSE OF RESALE CERTIFICATES

The 2005-06 Budget included Supplemental Report Language directing the BOE to report on the results of its pilot audit of compliance problems in the use of resale certificates. Resale certificates are forms given to retailers by purchasers who claim exemption from paying sales tax on the basis that they are a registered seller and the purchase is for resale.

The BOE has obtained a statewide database of tax-exempt sales for resale from a major "Big Box" retailer. Initial indications are that purchasers provided a significant number of invalid sellers permit numbers and that a significant amount of purchases using valid numbers appear to be for items that are not in purchaser's line of business (a jewelry purchase using a gas station resale permit, for example).

## COMMENTS

The board has not been able to fully analyze and follow-up on the information provided by the "Big Box" retailer at this time. However, BOE intends to do so in the next few months. Accordingly, staff suggests adoption to the following Supplemental Report Language:

> The State Board of Equalization shall report to the Legislature by January 1, 2007 on the results of its pilot audit of the use of resale certificates at a "Big Box" retailer. The report shall identify significant types of compliance problems, estimate revenue losses due to noncompliance and tax evasion, and make recommendations to improve compliance, including, if warranted, modifications to the resale certificate process such as the use of data-encoded permit cards.

# ITEM 1730 FRANCHISE TAX BOARD

## ISSUE 1: SAVINGS FROM ELECTRONIC PROCESSING

The subcommittee heard this issue on March 29th and held it open.

Information provided by FTB indicates ongoing growth in electronic filing of returns and remittances. This growth has occurred as a combined result of statutory mandates for tax practitioners as well as a “natural” migration from paper to electronic filing by individual and business taxpayers. The FTB reports that it expects 10 percent annual growth in electronic remittances through 2008, and 5 percent to 10 percent annual growth in electronic returns over the same period.

In the 2006-07 Budget Analysis, the LAO identified an additional $200,000 of savings from the growth in electronic processing and recommended an equivalent budget reduction. The FTB now has increased the savings estimate to $338,000.

## COMMENTS

The FTB argued for keeping the excess funding on March 29th on the basis that it needed the extra funds to help offset unallocated budget reductions.

The issue at hand demonstrates the inconsistency of unallocated reductions with principles of clear budgeting.

## ISSUE 2: SPRING FINANCE LETTER—CALIFORNIA CHILD SUPPORT AUTOMATION SYSTEM

A Spring Finance Letter requested conforming change in FTB reimbursements and the addition of Budget Bill Language providing additional authority to increase spending by the Department of Child Support Services (DCSS) and the Franchise Tax Board (FTB) with respect to the California Child Support Automation System (CCSAS), as follows:

**FTB—CCSAS-SDU Component (Issue 023)—**It is requested that Item 1730-001-0001 be amended by increasing Reimbursements by $256,000 (DCSS Issue 003 above).

The Section 11.00 notification dated March 14, 2006 for the CCSAS CSE component, relayed information provided by FTB and DCSS about anticipated future CCSAS Project requests. That notification also reported that additional CSE project documentation will be provided later this year that may include further CSE system changes. This Finance Letter and associated project documents are consistent with the information provided in the March 14, 2006 Section 11.00 notification. The FTB and DCSS continue to expect additional project changes but do not expect these changes to require corresponding changes in the SDU component because the payment processing activities of the SDU are not significantly affected with the introduction of Version 2. The FTB and DCSS advise that it is possible that the testing of CSE functionality and the experiences gained during the operational phase scheduled for July, may reveal problems that could require SDU changes. If resolution of these problems is essential to obtaining federal certification or to ensure accurate and timely payment processing, additional changes to the project with corresponding funding increases may be required.

**DCSS and FTB—CCSAS Augmentation Language (DCSS Issue 004, FTB Issue 024)—**It is requested that language be added to Items 1730-001-0001, 5175-101-0001, and 5175-101-0890 to authorize the Director of Finance to approve any augmentation for unanticipated CCSAS project expenses that are deemed necessary to meet federal certification requirements or immediately necessary for system functionality. All other CCSAS augmentations would be subject to 30-day legislative review. This language is proposed to mitigate critical path delays that would jeopardize meeting the September 20th certification deadline. The language will provide a mechanism to address unanticipated costs associated with the CCSAS project and to accommodate very short project timelines. The text of the proposed provisional language is included in Attachment A.

### COMMENTS

The Finance Letter requests Budget Bill Language to allow the Department of Finance to augment General Fund spending for CCSAS above the amount included in the 2006-07 Budget. The language provides that “if the Director of Finance deems that the augmentation is in the critical path to meet federal certification requirements and therefore necessitates immediate action or immediately necessary for system functionality, the Director may approve the augmentation. Any changes for these purposes would be excluded from the reporting requirements of Section 11.00.” In such a case, written notification would be required to the Legislature within 10 days after Finance approval of the contract. If those conditions are not met, project augmentations would be authorized after a 30 day advance notice to the Legislature. Language is also requested to allow $132 million federal funds in the 2006-07 budget to be available for expenditure through 2007-08.

**LAO Concern.** The LAO has expressed concern that the Budget Bill Language requested under the March 27th Finance Letter would inappropriately limit Legislative authority and oversight of the CCSAS Project, which has been, and continues to be, a massive undertaking with significant fiscal consequences for the state.

**Senate Action.** Responding to these concerns, Senate Subcommittee 3 acted to modify the proposed Budget Bill Language to 1) ensure Legislative oversight prior to mid-year spending increases, and 2) limit the amount of funding and time period for mid-year increases.

**Action Pending in Subcommittee 1**. Assembly Budget Subcommittee 1 heard this Finance Letter Request (regarding DCSS) on May 3rd and held it open pending resolution of another matter. In order to ensure consistency, action on the language request for FTB should conform to the action of Subcommittee 1 for DCSS.

## ISSUE 3: CONSENT—SPRING FINANCE LETTERS

A March 30th Finance Letter requested the following augmentation to the FTB budget:

**Phase III Occupancy Costs—Butterfield Office Complex (Issue 017)—**It is requested that Item 1730-001-0001 be increased by $21,611,000, Item 1730-001-0044 be increased by $101,000, Item 1730-001-0064 be increased by $188,000, Item 1730-001-0242 be increased by $282,000, and Reimbursements be increased by $1,854,000 to reflect facility related costs for the Franchise Tax Board's (FTB) Butterfield Office Complex. It also is requested that Item 8640-001-0001 be increased by $82,000 to reflect monies received pursuant to the Political Reform Act.

This request will pay for increased rental and maintenance costs for FTB's new Phase III buildings which they occupied in 2005.

**Tax Gap and Discovery Audits—Full Year Annualization (Issue 018)—**It is requested that Item 1730-001-0001 be increased by $659,000 to reflect full-year, ongoing funding for the tax gap and discovery audit program staff provided in the Budget Act of 2005.

## COMMENTS

No issues have been raised regarding these requests.

## ISSUE 4: CONSENT—MAY REVISION REQUESTS FOR THE CALIFORNIA CHILD SUPPORT AUTOMATION SYSTEM

The Governor's May Revision includes the following requested changes for the FTB related to the California Child Support Automation System:

**California Child Support Automation System (CCSAS) Data Capture Staffing (Issue 028)—**It is requested that Item 1730-001-0001 be revised by augmenting FTB staff by 8.0 positions so that the FTB may perform data capture services for the Department of Child Support Services (DCSS). Funding for these positions is contained as Issue 023 in the FTB Finance Letter dated March 27, 2006.

**CCSAS Business Partner Change Orders (Issue 029)—**It is requested that FTB federal funds reimbursement authority be decreased by $454,000 to reflect a reduction in the CCSAS Business Partner change order requests. This issue corresponds to DCSS Issue 108 in the DCSS May Revision letter.

**CCSAS Child Support Transitional Arrears System Change (Issue 030)—**It is requested that Item 1730-001-0001 be increased by $1,020,000 million General Fund, and that federal funds reimbursement authority be increased $1,980,000 million, for system updates associated with tracking the date when child support payments are received from non-custodial parents. This issue is associated with Issue 106 in the DCSS May Revision letter.

**Budget Bill Language**. It also is requested that the following provisional language be added in relation to this issue:

> Provision X. Of the amount appropriated in this item, $3,000,000 shall be available for enhancements to the California Child Support Automation System project to enable the receipt and recording of child support transitional arrears payments. This funding shall not be expended until the Department of Finance approves the Advance Planning Document/Special Project Report and no sooner than 30 days after notification in writing of the necessity thereof, is provided to the Chairperson of the Joint Legislative Budget Committee and the chairperson of the committee in each house of the Legislature that considers appropriations, unless the Chairperson of the Joint Legislative Budget Committee, or his or her designee, imposes a lesser time.

**Adjust Federal Funds Reimbursements for the California Child Support Automation System (CCSAS) Project—**It is requested that Franchise Tax Board federal funds reimbursement authority be increased by $43,000 to reflect an increase in federal funds available for the CCSAS project.

## COMMENTS

These requests are consistent with the current needs of the CCSAS Project and the requests made for the Department of Child Support Services. In addition, the Arrears System Change responds to concerns raised by legislative staff that the system design would result in erroneous arrearage notices for payroll deductions made on the last day of the month.