AGENDA
ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION

Assemblymember Juan Arambula, Chair

TUESDAY, APRIL 15, 2008, 1:30 PM
STATE CAPITOL, ROOM 447

CONSENT ITEMS

ITEM 0954 Scholarshare Investment Board

The ScholarShare Investment Board is the administrator for the Golden State ScholarShare College Savings Trust Program (ScholarShare), the Governor's Scholarship Program (GSP) and the California Memorial Scholarship Program (CMS). These programs encourage California citizens to pursue higher education by making education more affordable. ScholarShare encourages families to save for higher education costs, while GSP granted scholarships to students for use at eligible higher education institutions. CMS provides scholarships to surviving dependents of California residents killed in the terrorist attacks on September 11, 2001.

The Governor's proposed budget includes $2.4 million for the board, of which about $1 million is from the General Fund – and reflects a 10 percent Budget Balancing Reduction of $105,000.

ITEM 0956 Debt Investment Advisory Commission

The mission of the California Debt and Investment Advisory Commission (CDIAC) is to promote and improve the practice of public finance in California by providing responsive and reliable information, education, and advice. CDIAC assists state and local governments by providing education and information related to the effective and efficient issuance, monitoring, and management of public debt and prudent and safe investment of public funds.

The Commission consists of nine members including the State Treasurer, who serves as chairperson; the Governor or, upon his designation, the Director of Finance; the State Controller; two local government finance officers appointed by the State Treasurer; two members of the Assembly appointed by the Speaker of the Assembly; and two members of the Senate appointed by the Senate Committee on Rules.

The Governor's proposed budget includes $2.6 million (special funds) for the CDIAC.

ITEM 0959 Debt Limit Allocation Committee

The California Debt Limit Allocation Committee's mission is to allocate tax-exempt private activity bond authority for the State of California. Private activity bonds may only be used by the private sector for projects and programs that provide a public benefit. The major public benefit in California is the creation of affordable housing.

The Committee administers six programs that are funded through the allocation and issuance of tax-exempt private activity bonds. Those programs are: (1) the Qualified Residential Rental Project Program, (2) the Single-Family Housing Program, (3) the Extra Credit Home Purchase Program, (4) the Industrial Development Bond Project Program, (5) the Exempt Facility Program, and (6) the Student Loan Program.

The Committee is comprised of the State Treasurer as Chairperson, the Governor, or upon his designation, the Director of Finance, and the State Controller. The Committee is funded on a fee-supported basis.

The Governor's proposed budget includes $1.2 million (special funds) for the Committee.

ITEM 0965 Industrial Development Financing Advisory Comm.

The California Industrial Development Financing Advisory Commission's (CIDFAC) creates employment opportunities and supports local economic development. CIDFAC meets this goal by approving local entities' issuance of Industrial Development Bonds (IDBs). The IDBs provide manufacturers with a low-cost financing option to build or expand their operations. CIDFAC independently reviews IDB applications to ensure compliance with federal and state statutes and approves the sale of IDBs by local authorities. Additionally, CIDFAC provides technical assistance to local issuers of IDBs, including cities, counties, industrial development authorities, redevelopment agencies, and joint powers authorities.

The State Treasurer serves as chairperson of the CIDFAC. The other members are the Director of the Department of Finance, the State Controller, the Secretary of the Business Transportation Housing Agency, and the Commissioner of the Department of Corporations.

The Governor's proposed budget includes $331,000 (special funds) for CIDFAC.

ITEM 0968 Tax Credit Allocation Comm. (inc. Finance Letter.)

The mission of the California Tax Credit Allocation Committee (CTCAC) is to form public/private partnerships to assist in the development and maintenance of quality rental housing communities affordable to low-income Californians.
CTCAC works in public/private partnerships to assist with project development, while fulfilling its responsibilities as a credit agency through project compliance monitoring. CTCAC coordinates its functions with state and local housing fund providers and with private fund investors, when providing and maintaining quality, affordable housing.

The CTCAC consists of seven members, including the Treasurer who is designated as chairman, the Governor or Director of Finance, the State Controller, the Director of the Department of Housing and Community Development, the Executive Director of the California Housing Finance Agency, and two local government representatives.

The Governor's proposed budget includes $4 million (special funds) for CTCAC. In addition, the Administration submitted a Finance Letter requesting an increase of $674,000 for workload associated with federal compliance monitoring requirements.

ITEM 0971 Alt. Energy and Advanced Trans. Finance Auth.

The California Alternative Energy and Advanced Transportation Financing Authority was established by Chapter 908, Statutes of 1980, as the California Alternative Energy Source Financing Authority, to "promote the prompt and efficient development of energy sources which are renewable or which more efficiently utilize and conserve scarce energy resources." Recognizing the importance of developing a secure energy future to protect the environment and ensure economic stability, the intent of the legislation was to promote energy sources designed to reduce the degradation of the environment.

The Authority later became the California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA) in 1994, when the statute was amended to include development and commercialization of advanced transportation technologies. CAEATFA consists of five members: the State Treasurer, who serves as the chairperson of CAEATFA, the State Controller, the Director of Finance, the Chairperson of the State Energy Resources Conservation and Development Commission (the California Energy Commission), and the President of the Public Utilities Commission.

The Governor's proposed budget includes $204,000 (special funds) for CAEATFA.

ITEM 0977 Health Facilities Financing Authority

The California Health Facilities Financing Authority (CHFFA) issues revenue bonds to assist qualified private nonprofit corporations or associations, counties, and hospital districts in financing or refinancing the construction, equipping or acquiring of health facilities. CHFFA also administers the Children's Hospital Program established by Proposition 61. CHFFA was established by Chapter 1033, Statutes of 1979. CHFFA consists of nine members: the State Treasurer, the Director of Finance, the State Controller, two public members appointed by the Senate, two public members appointed by the Assembly, and two public members appointed by the Governor.

The Governor's proposed budget includes $251 million (special funds) for CHFFA.

ITEM 0985 School Finance Authority

Created in 1985, the California School Finance Authority (CSFA) oversees the statewide system for the sale of revenue bonds to reconstruct, remodel, or replace existing school buildings, and to acquire new school sites and buildings to be made available to public school districts, charter schools, and community colleges, and to provide access to financing for working capital and capital improvements. CSFA consists of the following three members: the State Treasurer who serves as chair, the Superintendent of Public Instruction, and the Director of Finance.

The Governor's proposed budget includes $10.9 million (primarily federal funds) for CSFA.

ITEM 0860 State Board of Equalization

1. **Cigarette and Tobacco Programs (BCP #4).** The budget requests $3.0 million ($238,000 General Fund), 13.0 new positions, and conversion of 20.0 limited-term positions to permanent, to enhance enforcement and voluntary compliance in the cigarette and tobacco product tax programs. The majority of the requested positions would work in the compliance and audit areas to address ongoing and new workload related to out-of-state tax avoidance, accounts receivable recovery, and tax audit activities. These efforts are expected to increase revenue by $30.1 million ($1.5 million General Fund) in 2008-09 and by $43.2 million ($1.9 million General Fund) in 2009-10. In addition to the General Fund benefit, the additional revenue collection would benefit programs funded out of the Breast Cancer fund, the Cigarette and Tobacco Products Surtax fund, and the California Children and Families First Trust Fund. The current tax is $.87 per pack of cigarettes.

2. **Agricultural Inspection Station Program (BCP #5).** The Administration requests $1.4 million ($800,000 General Fund), to continue for two years 16.0 limited-term positions that are associated with the Agricultural Inspection Station Tax Leads Pilot Program. Under this program, BOE staff is co-located with the Department of Food and Agriculture staff at the California border inspection stations for the detection and identification of property brought into California without payment of the sales and use tax. These continued efforts are expected to increase revenue by $6.35 million ($3.6 million General Fund) in both 2008-09 and 2009-10.

ITEM 1730 FRANCHISE TAX BOARD

1. **California Child Support Automation System (BCP #15 and April Finance Letter)** The proposed budget includes $7.9 million (General Fund) and a decrease of $15.8 million in reimbursements to align the California Child Support Automation System (CCSAS) to the revised project documents. This information-technology project is managed by the FTB as an agent of the Department of Child Support Services (DCSS). The Department reports that in May 2007, the pilot counties for Version 2 were rolled out and the final county (Los Angeles) will be fully transitioned to the statewide system in November 2008. The April Finance Letter requests the shift of $44.5 million General fund and $44.1 in Reimbursement authority, as well as 146.0 positions to the Department of Child Support Services (DCSS) to affect the transfer of full responsibility for implementation of the CCSAS Project from FTB to DCSS. Since the Department of Child Support Services is in Subcommittee #3, staff will monitor that committee's actions related to CCSAS and bring any conforming changes to Subcommittee 1 as needed.

2. **Encoder Replacement (BCP #5).** The budget requests a one-time augmentation of $1.2 million ($1.1 million General Fund) to replace three existing encoders. The existing encoders identify each check and money order, encodes it with the correct money amount, endorses it, and then sorts it to the correct bank. They have reached the manufacture's "end of life" and therefore face an increasing risk of failure. The new encoders will also be able to scan smaller documents (currently processed on large high-speed scanners) thus allowing FTB to scan tax returns and other larger documents more quickly and improve efficiency. If one of the existing encoders were to fail during a busy tax period, deposits could be delayed, resulting in a General Fund interest loss of up to $100,000 per day.

3. **Security Workload Growth (BCP #9).** The budget requests an augmentation of $27,000 ($14,000 General Fund), a redirection of $440,000 (all General Fund) from E-File and E-Services savings, and 4.7 two-year limited-term positions (and deletion of 8.0 existing positions no longer needed because of E-File and E-Services), for securing FTB's critical assets and protecting confidentiality of taxpayer data. Of the 4.7 positions, 2.7 positions would address *inside* security threats such as inappropriate employee access or use of taxpayer information. The other two positions would address *external* security threats such as inappropriate vender activity or unauthorized access to FTB data and systems.

4. **Court Ordered Debt Collection (BCP #7 & April Finance Letter).** The Administration requests $3.9 million (Court Collection Fund) and 56.5 positions (26.5 new positions, conversion of 12 limited-term positions to permanent, and 18 continuing limited-term positions) to continue the development and implementation of the Court Ordered Debt (COD) information technology project, and support the increase in collection program activities. The COD program has authority to collect delinquent court-imposed fines, penalties, forfeitures, and restitution orders. The April Finance Letter requests the addition of a budget bill provision to specify that the 15 percent limit on FTB administrative costs for court debt collection may be exceeded in 2008-09 due to the one-time costs of implementing the information technology project. Since 1995, $320 million has been collected by FTB for the courts. Revenue collected supports county accounts, the State Restitution Fund, Victims-Witness Assistance fund, as well as the State General Fund. Collection activity has increased in recent years and this request supports the increased workload.

5. **Limited Liability Corporation – Court Decision (April Finance Letter).** The Finance Letter requests $178,000 (General Fund) and 3.0 two-year limited-term positions to process the refunds of 4,000 claimants covering 10,000 tax years. The FTB was ordered by the California Court of Appeals to return a portion of the Limited Liability Corporation (LLC) fees paid by LLCs doing non-reportable business in California. These staff are needed to comply with the court order.

ITEM 8885 Commission on State Mandates

1. **Schedule Update for Two New Mandates (April Finance Letter).** The Administration requests amendments to the main mandate payment item in the budget bill to reflect the following two new mandates (1) DNA Database & Amendment to Post Mortem Exams: Unidentified Bodies (Ch. 822, St 2000; Ch 467, St 2001); and (2) Handicapped and Disabled Students II (Ch 1128, St of 1994; Ch 654, St 1996). No additional budget funding is needed for these mandates in 2008-09.

ITEMS TO BE HEARD

ITEM 8855 BUREAU OF STATE AUDITS

The California State Auditor promotes the efficient and effective management of public funds and programs by providing independent, objective, accurate, and timely evaluations of state and local governmental activities to citizens and government. By performing financial, compliance, and performance audits, conducting investigations and other special studies, the State Auditor provides the Legislature, the Governor, and the citizens of the state with objective information about the state's financial condition and the performance of the state's many agencies and programs.

ISSUE 1: BUDGET BALANCING REDUCTION - UNALLOCATED

The Governor's budget includes a $1,628,000 General Fund unallocated reduction to the Bureau of State Audits (BSA) budget.

BACKGROUND

Upon learning of the Administration's plan to reduce the BSA's budget, the State Auditor sent a letter to the Director of the Department of Finance (DOF) to remind him of a Memorandum of Understanding (MOU) signed in 1994, by the BSA and the DOF. The MOU directly quotes Government Code Section 8543 (part of the BSA's implementing legislation), which reads in part:

> *In order to be free of organizational impairments to independence, the bureau shall be independent of the executive branch and legislative control.*

The MOU also recognizes another code section that provides that the BSA be "free from influence of existing control agencies that could be the subject of audits." In short, the State Auditor asserts that only the Legislature may order changes to the BSA's budget.

COMMENTS

Given the important role the BSA's independent audit function plays in providing the Legislature, the Governor, and the public with objective information about the state's financial condition and the performance of state agencies and programs, the subcommittee may wish to reconsider whether a reduction to the BSA's budget might wind up costing the state more money than it saves.

ITEM 0950 STATE TREASURER

The State Treasurer, a constitutionally established office, provides banking services for state government with goals to minimize interest and service costs and to maximize yield on investments. The Treasurer is responsible for the custody of all monies and securities belonging to or held in trust by the state; investment of temporarily idle state monies; administration of the sale of state bonds, their redemption and interest payments; and payment of warrants drawn by the State Controller and other state agencies.

ISSUE 1: PROPOSED BUDGET AND FINANCE LETTER

The Governor's proposed budget includes $26.8 million ($6.5 million General Fund) for the State Treasurer. This reflects a 10 percent unallocated Budget Balancing Reduction of $715,000.

In addition, the Administration has submitted a Finance Letter requesting an increase in reimbursement authority of $184,000 to assist the Treasurer's office achieve the 10 percent General Fund reduction.

COMMENTS

The Treasurer's office should report at the hearing regarding the plans for implementing the 10 percent General Fund reduction and how the Finance Letter request is related to these efforts.

ITEM 0860 STATE BOARD OF EQUALIZATION

The Board of Equalization (BOE) administers the sales and use tax programs, administers a variety of business and excise taxes and fees, and oversees the administration of the property tax by county assessors. The BOE is governed by a five-member board, consisting of four regionally elected members and the State Controller. The Board is also the final administrative appellate body for personal income and corporation taxes, which the Franchise Tax Board (FTB) administers.

The Governor proposes expenditures of $430 million ($242 million General Fund) and 4,035 positions for BOE – an increase of $33 million ($20 million General Fund) and an increase of 235 positions. The new positions are primarily associated with activities that will decrease the "tax gap," which is the $2.0 billion annual difference that BOE estimates (for the General Fund taxes that it collects) between the amount of taxes owed and the amount of taxes collected. The Board estimates that the requested tax-gap positions will increase General Fund revenues by over $32 million in 2008-09.

The Governor did not propose any Budget-Balancing Reductions for the board, but, instead, included the tax-gap proposal to generate additional revenue.

ISSUE 1: ELECTRONIC FILING EXPANSION

The Governor's Budget requests a 2008-09 augmentation of $4.7 million ($1.7 million General Fund), and 3.0 new positions to support expanded efforts in the area of electronic filing. This is a multi-year proposal and the anticipated 6-year cost is expected to be $16.5 million with a 6-year revenue benefit of $27.6 million.

This request includes the following five components:

1. ***Internet Registration.*** Expand on-line registration to all tax and fee programs and allow tax and fee payers to enter business/personal information one time for all permits/licenses required by the BOE.

2. ***E-Filing for Special Taxes.*** Add e-filing for special taxes, which will improve accuracy, audit selection, and efficiency.

3. ***E-Filing for Fuel retailers and Distributors***. Add e-filing for fuel taxes to speed reconciliation with associated sales tax payments and improved BOE efficiency.

4. ***On-line Requests for Extensions, etc.*** Add functionality to increase BOE efficiency by automating existing manual processes.

5. ***On-line Requests for Installment Payment Agreements.*** Add functionally to increase BOE efficiency by automating manual processes.

LAO Recommends Recognition of Saving

In the *Analysis of the 2008-09 Budget Bill*, the Legislative Analyst's Office (LAO) does not raise any concerns with this specific request, but does recommend that the BOE's budget be reduced by $1.4 million (General Fund) to account for anticipated e-file saving in 2008-09 that will result from past BOE e-file initiatives.

COMMENTS

- The $1.4 million savings in ties to BOE's own savings projection for 2008-09.

- Although BOE has indicated that it would prefer to retain the e-filing savings for additional revenue positions, the proposed budget already requests a substantial number of new positions to narrow the tax gap. Furthermore, requests for additional resources should be justified on their own merits in the context of overall budget priorities—not just within one department.

ISSUE 2: EXPANDING EFFORTS TO ADDRESS THE TAX GAP

The Governor's Budget requests an augmentation of $13.9 million ($9.0 million General Fund) and 129.4 personnel-years (PYs) of additional staff in 2008-09 to expand efforts to narrow the Sales and Use Tax (SUT) gap so that more of the revenue that is owed is collected. Some positions phase-in during the year, and additional positions would be added in 2009-10 to bring the total staffing increase up to 241.1 PYs. Total funding would increase to $22.9 million ($14.9 million General Fund) in 2009-10. All but three of the additional positions that would be added are proposed to be permanent. The BOE estimates this proposal would result in additional revenues of $32.3 million ($20.0 million General Fund) in 2008-09 and $60.9 million ($38 million General Fund) in 2009-10. The non-General Fund portion of both the costs and the revenues would be paid from, or accrue to, SUT revenues allocated to local governments.

Description of the Proposal

This request includes the following five components:

1. ***Bankruptcy / Out-of-State Collections – 5.0 positions and $545,000 ($354,000 General Fund)***. Funding includes a contract with FTB for bankruptcy data for out-of-state taxpayers, and additional BOE staff to speed the filing of tax liens and improve the State's lien priority for bankruptcy liquidation. The projected revenue gain is $4.2 million ($2.6 million General Fund) in both 2008-09 and 2009-10.

2. ***In-State Service Businesses – 51.5 positions and $4.7 million ($3.1 million General Fund)***. This request would increase compliance of use tax payment by service businesses inside the state that purchase goods outside the state. The projected revenue gain is $13.6 million ($8.8 million General Fund) in 2008-09 and $26.4 million ($16.0 million General Fund) in 2009-10.

3. ***Collection Improvements – 14 positions and $1.3 million ($861,000 General Fund).*** This request would increase audit activity and generate estimated revenue gains of $2.9 million ($1.8 million General Fund) in 2008-09 and $5.8 million ($3.7 million General Fund) in 2009-10.

4. ***Audit Improvements – 63.0 positions and $7.0 million ($4.6 million General Fund).*** This request would increase audit activity, in part to take advantage of recently purchased analytic modeling software and the application of data-matching techniques. The augmentation includes 24 auditors to audit out-of-state accounts. The board estimates that these resources will generate $11.6 million ($7.6 million General Fund) in 2008-09 and $24.6 million ($16.0 million General Fund) in 2009-10.

5. ***Non-Filers and Tax Evaders Discovery Research – 3.0 positions (3-year limited term) and $351,000***. These staff would perform research and survey work to develop procedures and leads to investigate, to narrow the tax gap for (1) internet sellers, (2) itinerant vendors, and (3) cash-based businesses. No revenue is scored for this effort, but BOE hopes this discovery research would result in future tax gap initiatives.

It should be noted that the growth in the estimated revenue gains in 2009-10 is accompanied by an almost equivalent growth in costs and the number of staff.

LAO Recommendations

The LAO's chart below summarizes the costs and revenues of the five components of the BOE's tax gap proposal and shows the benefit-to-cost ratio for each in 2009-10 (when they would reach full staffing).

Figure 1

SUT Gap Initiatives

(All Funds, Dollars in Thousands)

	Costs		Revenues		Average Benefit/ Cost Ratio
Initiative	**2008-09**	**2009-10**	**2008-09**	**2009-10**	**2009-10**
Expanded Bankruptcy/ Out-of-State Collection	$545	$735	$4,201	$4,201	5.7
In-State Service Businesses	4,693	8,411	13,609	26,358	3.1
Collection Improvements	1,325	2,126	2,932	5,772	2.7
Audit Improvements	7,002	11,330	11,578	24,570	2.2
Non-Filers and Tax Evaders	351	318	—	—	—
Totals	**$13,916**	**$22,920**	**$32,320**	**$60,901**	**2.7**

Source: Legislative Analyst's *Analysis of the 2008-09 Budget Bill*, page F-56.

LAO makes the following observations and recommendations regarding this budget proposal (with BOE responses noted):

Some Revenues Are Understated. LAO indicates that the administration's proposals for expanded bankruptcy and out–of–state collections would generate more revenue than budgeted, LAO recommends scoring an additional $84,000 in revenue in 2008–09 ($53,000 General Fund) and an additional $1.3 million in revenue in 2009–10 ($0.8 million General Fund) and annually thereafter.

Some Initiatives Have Little Benefit. As shown in Figure 1, most of the board's initiatives (as presented in the budget) have low benefit–cost ratios. For instance, BOE's proposed audit improvement and collection improvement initiatives would bring in less than $3 for each $1 spent by 2009–10. In contrast, FTB's tax gap proposals would bring in an average of $10 for each $1 spent. On that basis LAO recommended rejecting the audit improvement and collection improvement initiatives. LAO also recommended rejecting the field audit and collection component of the in–state service businesses proposal. The 9.5 PYs associated with these activities would cost about $884,000 in 2008–09 and produce $1 million in revenue. A year later, the new staff would grow to 37 PYs and cost about $3.4 million in return for less than twice that amount in revenue. After adjusting for the field component, LAO recommends approval of $3.8 million of the in–state service businesses initiative at headquarters due to a higher benefit–cost ratio.

Focus Pilot Programs. As described above, BOE proposes to conduct three pilot programs which are not expected to generate near–term revenues. Given the state's limited resources, LAO recommends limiting the pilot programs to those areas which offer the greatest potential for a substantial revenue return in the future. LAO believes that the Internet sellers activities pilot program meets this criterion (but not the itinerant vendor and cash businesses pilots).

Summary of LAO Recommendations:

Due to the poor expected revenue benefit associated with audit, collection, and pilot program activities, LAO recommends reducing the BOE request by $9.4 million (total funds) with an associated revenue reduction of $15.4 million (total funds) as follows:

1. Delete $7 million from audit improvements.

2. Delete $1.3 million from collection improvements.

3. Delete $884,000 from in–state service business activities.

4. Delete $232,000 from nonfiler and tax evader pilot programs.

LAO Recommends Augmentations at FTB Instead. While recommending reductions in the BOE proposal, LAO also recommends a number of augmentations at the Franchise Tax Board (discussed later in this agenda), which have higher rates of return and more than make up for the loss of revenue here (for the General Fund). A number of these have now been adopted by the administration as Finance Letter requests.

BOE Responses

Understated Revenue. In reviewing the estimate, BOE identified an additional error—revenue was assumed on a full-year basis for certain positions that will not start until January. This *reduces* the revenue estimate by $530,000 ($334,000 General Fund). Revenue in 2009-10 *will* increase by $84,000.

BOE Revenue Estimates Have Increased. The board has updated its revenue estimates for the Tax Gap proposal to reflect more recent audit and collections experience (2006-07). These new estimates are for the in-state service business component; the audit improvement component, and the collection program improvement component. The new estimates increase projected revenue gains by $11.2 million ($7 million General Fund) in 2008-09 and by $23.5 million ($14.5 million General Fund) in 2009-10. Costs remain the same, so that generally these improved revenue estimates lift the average benefit/cost ratio for these program components to 3.0 in 2008-09 and to 3.7 in 2009-10.

COMMENTS

1. ***New Estimates.*** LAO should advise the subcommittee as to whether they have had a chance to review the new BOE revenue estimates and whether the new estimates warrant any revision to their recommendations.

2. ***Some of the requested additional positions could be absorbed.*** For example, BOE indicates that in March it had 49 vacancies (including leaves of absence) in excess of budgeted salary savings—a modest number, given the size of BOE, but there nevertheless. Furthermore, many of the requested new positions have July 1, 2008 start dates and only normal salary savings is budgeted for them. Using the excess vacancies and applying somewhat more realistic hiring assumptions could reduce the cost by perhaps several hundred thousand dollars.

3. ***Better Opportunities?*** BOE has proposed that it be allowed to retain the e-filing savings (discussed in Issue 1, above) and redirect the funds to other audit and collection activities by adding between 9 and 15 PYs of staff. As identified by BOE, these additional efforts, while having a law benefit/cost ration (2.4) in 2008-09, have a much higher return (benefit/cost of 6 to 7) in subsequent years—higher than the returns in the actual budget request. This opportunity should be evaluated to determine if these efforts should replace a small part of the budget request resources or provided as an additional augmentation (or absorbed by using vacancies).

4. ***Should FTB Assist in Collections?*** The FTB has a well-developed collections process in place that also serves other agencies, such as the courts and the Department of Child Support Services. Certainly, it makes sense for BOE to make the initial efforts to collect the taxes and fees that it administers, but it may be more efficient, particularly for bankruptcies and out-of-state collections to contract with FTB. The BOE budget proposal did not evaluate this option

5. ***Use of Local Assessors' Information and Resources.*** Last year, the Legislature provided (but the Governor vetoed) $400,000 for a pilot program for the BOE to work with several county assessors to improve awareness of the use tax and improved compliance. Assessors have substantial field staff already in place throughout the state and businesses, including service businesses, must file annual personal property reports with the assessors. Trailer Bill legislation last year also clarified that information in the personal property reports can be used to assist in use tax compliance and awareness. Despite this recent legislative action, the board's budget proposal did not evaluate coordination to make use of existing resources of the assessors. The board should do so.

6. ***Use Tax Registration?*** One approach to improving use tax compliance by service businesses would be to require them to register with BOE and file periodic use tax reports. Currently BOE only registers businesses who engage in retail sales. Registration and reporting would give BOE a much better linkage to these businesses, and reporting would both increase voluntary compliance and provide BOE with an important audit and enforcement tool. BOE should advise the subcommittee regarding its current authority to require service businesses to register and report, whether such requirements would improve compliance and ease enforcement, and whether registration and reporting should be limited to certain categories or sizes of service businesses.

ISSUE 3: STATEWIDE COMPLIANCE AND OUTREACH

The BOE budget requests an augmentation of $11.6 million ($7.5 million General Fund), and 112.0 three-year limited-term positions (including the extension of 32.8 existing limited-term positions) to identify and register entities that actively engage in business in California and sell tangible personal property without a seller's permit. The BOE estimates this proposal would result in additional revenues of $60.2 million ($37.9 million General Fund) in 2008-09 and $81.1 million ($51 million General Fund) in 2009-10.

BOE indicates this proposal will increase the number of permitted businesses operating in California by about 7,258 per year. Bringing businesses out of the underground economy levels the playing field for compliant businesses and reduces the tax gap.

This proposal has a net General Fund benefit of $30.4 million in 2008-09, and benefit/cost ratio exceeding 5.

ITEM 1730 FRANCHISE TAX BOARD

The Franchise Tax Board (FTB) administers the personal income tax (PIT) program and the corporation tax (CT) programs. The FTB also administers the Homeowners' and Renters' Assistance Programs. The department also performs some non-tax collection activities, such as the collection of child support payments and other court-ordered payments. The FTB is governed by a three-member board, consisting of the Director Finance the Chair of the Board of Equalization, and the State Controller. An executive officer, appointed by the board, manages the daily functions of the department.

The Governor proposes expenditures of $650 million ($554 million General Fund) and 5,348 positions for FTB – a decrease of $45 million (but a General Fund increase of $19 million) and an increase of 182.5 positions. The new positions are primarily associated with activities that will decrease the PIT and CT "tax gap," which is the $6.5 billion estimated annual difference between taxes owed and taxes collected. The department estimates the requested tax-gap positions will increase General Fund revenues by over $90 million in 2008-09. Finally, the budget includes a minor adjustment to reflect a new voluntary contribution checkoff on tax returns – specifically, the California Sea Otter Fund (BCP 13), which was established by AB 2485 (Ch 296, St of 2006). The budget includes $6,000 from the California Sea Otter Fund to pay the FTB cost of administering the program.

The Governor did not propose any Budget-Balancing Reductions for the board, but, instead, included the tax-gap proposals to generate additional revenue.

ISSUE 1: BASE TAX GAP REQUEST

The Governor's Budget requests an augmentation of $6.5 million (General Fund), and 68.5 new positions to support expanded efforts to narrow the tax gap. The FTB estimates this proposal would result in additional General Fund revenues of $22 million in 2008-09 and $38.5 million in 2009-10.

BACKGROUND

This request consists of three components:

1. ***Fraud Prevention and Detection (32 positions and $2.4 million).*** Of these resources, 18 positions would help reduce fraudulent use of the child and dependent care credit ($8.3 million General Fund savings in 2008-09 and $13.9 million in 2009-10), and the remaining 14 positions would help reduce fraudulent W-2 filings and reduce fraudulent refunds ($4.1 million General Fund savings in 2008-09 and $6.7 million in 2009-10).

2. ***Audit Workload Growth (36.5 positions and $4.0 million).*** This component of the request brings staffing to the level needed to address all audit workload that statistically should produce an average benefit/cost ratio of 4 (by the second year). Typically in the past, a ratio of 5 had been the threshold. ($10.0 million General Fund revenue in 2008-09 and $20.0 million in 2009-10).

3. **Compliance Behavior Study ($100,000).** This request is for external consultants to measure the indirect effect, or change in taxpayer behavior, from FTB's various compliance activities.

COMMENTS

Revised Revenue Estimate. The LAO raised technical issues concerning the calculation of savings. The FTB has revised its revenue estimate and indicates that revenue in 2008-09 should be $300,000 higher in 2008-09 than the $22 million currently scored in the Governor's Budget from this proposal.

ISSUE 2: ADDITIONAL TAX GAP PROPOSALS

Governor's Budget

The Governor's Budget supplements the original FTB tax gap request (discussed in Issue 1, above) with additional proposals that would increase the budget by $9.9 million (General Fund), and 138.7 new positions. The FTB estimates this proposal would result in additional General Fund revenues of $71 million in 2008-09 and $125 million in 2009-10.

This request consists of five components:

1. ***New Data Source Pilot (14.5 positions and $1.0 million)***. These resources are requested to better focus collection of unpaid tax debt by using Department of Motor Vehicles data on luxury auto registrations (cars with a value exceeding $40,000). This data should improve the ability of FTB to collect more of the $7.3 billion in unpaid tax debt that has an “uncollectible status” ($27.0 million General Fund revenue in 2008-09 and $27.0 million in 2009-10).

2. ***Vendor Contract / Administration for Non-Filer Mailing Addresses (35.0 positions and $2.6 million).*** These positions and contract funds are requested to purchase good/mailable addresses from vendors in order to send notices to non-filers with bad addresses. These contracts and associated FTB administration would allow the department to contact an additional 110,000 non-filers annually ($7.1 million General Fund revenue in 2008-09 and $23.0 million in 2009-10).

3. ***IRS Information Return Master File-IRMF (26.2 positions and $2.1 million).*** These staff and contract funds are requested for a $250,000 vendor contract and State staff to more effectively analyze and use federal IRMF data, which includes payer and payee interest, partnership / S Corporations, distributions, gambling winnings and miscellaneous other categories. FTB believes they can better mine this data to identify an additional 60,000 non-filers annually, and better focus collection efforts ($13.4 million General Fund revenue in 2008-09 and $46.8 million in 2009-10).

4. ***Collection Program Workload Restoration (60.0 positions and $4.1 million).*** This request restores position reductions in 2003-04 and certain reductions to absorb price increases in 2005-06 and 2007-08 that reduced collection activity ($18.5 million General Fund revenue in 2008-09 and $18.5 million in 2009-10).

5. ***Mandatory E-Pay for PIT Payments over $20,000 (3 positions and $161,000)***. This request would implement mandatory electronic payment of estimated tax payments that exceed $20,000 or payment of tax liabilities of $80,000 or more, as is currently the case for corporation tax payments. This change would reduce deposit delays and increase the interest earnings of the state. FTB indicates that 1.8 percent of taxpayers would be affected, but those taxpayers pay over 50 percent of PIT revenues. New Jersey, Massachusetts, and Illinois currently have mandatory electronic payment requirements. ($5.0 million General Fund revenue in 2008-09 and $10.0 million in 2009-10).

Tax Gap April Finance Letter

In the *Analysis of the 2008-09 Budget Bill*, the Legislative Analyst recommends additional measures for the FTB to narrow the tax gap and increase General Fund revenue. The Administration has adopted some of these recommendations in an April Finance Letter, and also suggested a new tax gap proposal.

The Finance Letter includes two requests:

1. ***IRS Revenue Agent's Reports (LAO and Finance Letter) – 29.5 positions and $2.0 million***. These additional staff are requested to analyze the growing number of IRS Revenue Agent's Reports (RARs), which detail additional federal tax liability from high-income individuals. The FTB receives these IRS reports, and, generally, the federal audit finding of unpaid tax liability correlates with additional State liability. ($27.0 million General Fund revenue in 2008-09 and $38.4 million in 2009-10).

2. ***Collection of Inactive Accounts Receivable (Finance Letter) – 9.0 positions and $576,000.*** This request would increase collection efforts on outstanding accounts that have been placed in discharged status. (General Fund revenue gain of $8.0 million in 2008-09 and ongoing).

Additional LAO Tax Gap Proposal

LAO also has recommended the following additional tax gap effort:

Modify Group Income Tax Return Provisions ($100,000 and Trailer Bill Language). LAO recommends a statutory change to increase the number of non-residents who are eligible for inclusion in group tax returns, thereby assisting in identifying current non-filers. Under existing law, certain non-residents who receive income from a pass-through entity (a partnership or S corporation, for example) that derives income from California sources can elect to have the pass-through entity file a group nonresident return on their behalf. By expanding eligibility for group returns for non-residents with a tax liability exceeding $1.0 million, more non-residents who are not currently filing individual California returns should begin to file via group returns. ($2.0 million General Fund revenue in 2008-09 and $6.0 million in 2009-10).

COMMENTS

- ***LAO and DOF Agree.*** The LAO recommends approval of the Governor's Budget and Finance Letter requests and the Department of Finance has indicated that it does not object to the additional LAO proposal described above.

- ***Some of the requested additional positions could be absorbed.*** LAO's analysis of the State Controller's records indicates that FTB has had a vacancy rate of 11 percent recently. However, the FTB budget assumes vacancies of only 7.5 percent (6.3 percent on a dollar basis). Furthermore, many of the requested new positions have July 1, 2008 start dates and only normal salary savings is budgeted for them. Using the excess vacancies and applying somewhat more realistic hiring assumptions could reduce the net additional cost of the tax gap proposals. The LAO and FTB would need to work to identify an appropriate amount of savings.

- ***Mandatory E-Pay Statutory Change.*** The Administration did not submit trailer bill language associated with Component #5 of the Governor's Budget tax gap request (Mandatory E-Pay). The statutory changes are contained in AB 2755 (Hayashi), which is sponsored by FTB and was scheduled to be heard in the Assembly Revenue and Taxation Committee on April 14. The FTB and Department of Finance should advise the Subcommittee as to whether they want the language in AB 2755 to be included as Trailer Bill legislation. If not, then this component of the budget request should be attached to the separate legislation.

- LAO also recommended an augmentation for Out-of-State Audit Workload (10.0 positions and $500,000). However, staff understands that LAO now is suspending that recommendation because the bulk of the benefits are several years out.

- FTB's budget includes an additional request related to its "Withhold at Source" system. However, additional necessary justification was not provided in time for this hearing.

ITEM 8885 COMMISSION ON STATE MANDATES

The Commission on State Mandates (Commission) is responsible for determining whether a new statute, executive order, or regulation contains a reimbursable State mandate on local governments and determining the appropriate reimbursement to local governments from a mandate claim. This budget item appropriates the funding for the staff and operations cost of the Commission and appropriates non-Proposition-98 mandate payments for allocation to local governments by the State Controller.

The Governor proposes expenditures of $142.6 million ($140.7 million General Fund) and 12.0 positions (a decrease of 1 position). Included in these numbers, is a proposed 10-percent Budget-Balancing reduction of $168,000 and 1.0 position to the Commission's administration. The Budget also reflects the proposal, which was adopted in the Special Session, to discontinue the practice of paying *estimated* claims, and only pay claims once the full-year's cost has been incurred and filed with the State. This action reduced General Fund costs by $75 million in 2008-09 by shifting that cost to 2009-10.

Post Proposition 1A, the State generally is required to pay past mandate claims of local governments unless it suspends a mandate. The budget includes $64.0 million General Fund for this purpose. Proposition 1A also requires the repayment of all pre-July 1, 2004, mandate claims over a number of years (statute has established a 15-year period). The budget includes $75 million (General Fund) to pay a portion of the $900 million in outstanding pre-July 1, 2004 mandate claims.

ISSUE 1: MANDATE WORKLOAD

Incorrect Reduction Claims. The commission indicates that it has before it a total of 137 pending incorrect reduction claims (IRCs) for adjudication, of which 81 have been filed by local governments (the others were filed by K-14 education entities). The local government IRCs seek reinstatement of $14.9 million of reductions that the State Controller made to various claims. The commission did not make any IRC determinations in 2007.

Mandate Test Claims. The commission indicates that it currently has before it 22 local government test claims that seek a determination of new mandates. These include several test claims seeking mandate determinations for orders of the Regional Water Quality Control Boards.

COMMENTS

1. The commission should inform the subcommittee regarding its ability to process the adjudications of IRCs and test claims in a timely manner.

2. The commission, Department of Finance and LAO should comment on the potential fiscal impacts of the pending test claim mandates should the commission determine that they are reimbursable mandates.

ISSUE 2: LAO RECOMMENDATION—ANIMAL ADOPTION

Background

Chapter 752, Statutes of 1998 (SB 1785, Hayden) declared "It is the policy of the state that no adoptable animal should be euthanized if it can be adopted into a suitable home," and (2) lengthened the time (generally from three days to six) that shelters must care for animals before euthanizing them. When the Legislature considered Chapter 752, it was advised that the measure would not impose a state–reimbursable mandate because shelters would receive increased adoption and owner–redemption fees. These fees would offset shelter costs to care for the animals for the longer period.

Shortly after Chapter 752 was enacted, local governments filed a mandate test claim with the commission. In the case of animals that were euthanized, however, the commission found that local government shelters' cost to care for them for three additional days was a state–reimbursable mandate. In 2008–09, local governments are expected to claim $23 million for this mandate. Almost all of the cost is for the food, medical care, and space needed to keep animals alive for the longer period. Private shelters are not eligible for the mandate reimbursements.

LAO Finds Mandate Approach Ill-Suited to Increasing Adoptions

LAO indicates that Chapter 752's requirement that shelters keep animals alive longer increases the supply of animals in shelters on any specific day. It also gives animal rescue organizations more time to transfer animals to their facilities. This increased supply of adoptable animals (at shelters and rescue facilities) can give households greater choice in selecting a pet to adopt. It does not necessarily mean, however, that more households adopt pets. That is, the mandate does nothing to increase the demand for these animals.

Indirect Effect of Shelter Funding. To increase the number of pets adopted, LAO points out that more households need to adopt pets rather than buy them from stores or breeders. Especially over the last decade, as concern regarding the treatment of animals has grown, many shelters, animal rescue, and humane groups have taken significant steps towards promoting animal adoption. LAO, however, finds no link between the funding provided under Chapter 752 and programs that encourage animal adoption. Specifically, under the mandate's reimbursement methodology, shelters do not get more state funds if more households adopt animals. Rather, shelters that euthanize the most animals receive the *most* state funds. Shelters that are the most successful in promoting adoptions receive the *least* state funds.

LAO Recommendation

Because LAO finds no evidence that the longer holding period (or its mandate funding) furthers state policy objectives, LAO recommends that the Legislature repeal this requirement of Chapter 752 (along with the other minor elements of the measure found to be a mandate). This action would eliminate the state's obligation to reimburse local governments for their increased costs of caring for animals that they euthanize. If the Legislature wishes to give shelters more incentives to promote animal adoptions, LAO recommends trying a different approach. For example, the Legislature could pilot an incentive program that gives funding to those shelters that increase the number of animals successfully adopted. (As a point of reference, based on information provided by the Department of Public Health, the state could give local government shelters $30 for every dog or cat adopted for a total annual cost of about $12 million.)

Net Savings of $10 million. The LAO's recommendation would (1) reduce by $13 million the funds provided in the budget bill for this mandate to pay 2005–06 and 2006–07 mandate claims, and (2) increase by $3 million the funds provided in the budget to make a payment for the mandate backlog and prior year Animal Adoption claims. The net 2008-09 impact would be a savings of $10 million.

ISSUE 3: WOULD A BLOCK GRANT APPROACH WORK BETTER?

Recent legislation (AB 1222, Laird, enacted in 2007) provides new options to facilitate the mandate determination process and the process of establishing reimbursement guidelines. These options allow local entities, the Department of Finance, and the commission to work collaboratively to identify reimbursable mandates and to negotiate reasonable reimbursement guidelines that can be approved by the commission. The intent is to move away from cumbersome and time-consuming adjudicatory processes, when possible.

However, the mandate claiming process remains cumbersome. It currently requires detailed recordkeeping on the part of local entities in most cases, and engenders numerous disputes between local claimants and the state (which result in incorrect reduction claims, as noted above).

An alternative approach that may have merit, at least for some mandates, would be to enact a "block grant" program as a substitute. Under a block grant approach, the selected mandated programs would be come optional (thus *requiring* no state reimbursement). However, local governments that agree to carry out the now-optional mandates would receive a block grant of funds from the state. There would still be a need to verify that local governments were, indeed, carrying out the programs, but there also could be more flexibility to enable local governments to focus resources in ways that best meets local needs and conditions, rather than structuring their programs to meet a set of state claiming guidelines.

COMMENTS

- The subcommittee may wish to ask LAO, DOF, and local government representatives for their assessment of whether a block grant approach might be an alternative worth exploring, and perspectives on the following specific features:
  - Which types of mandates would be best suited to a block grant approach?
  - How should the amount of total funding and the allocations to each local government be determined?
  - How should compliance be verified?
  - Should local flexibility be provided and, if so, how?

ITEM 9100 TAX RELIEF

This budget item includes several programs that provide tax relief by: (1) making payments to individuals to partially offset their property tax payment (or rent in the case of renter), and (2) making payments to local governments to help defray revenues lost as a result of tax relief programs. There are five tax relief programs funded in this item, and the funding amount indicated is the amount budgeted (all General Fund) prior to proposed budget-balancing reductions:

1. Senior Citizens' Property Tax Assistance ($40.6 million)
2. Senior Citizens' Property Tax Deferral Program ($25.8 million)
3. Senior Citizen Renters' Tax Assistance Program ($150.3 million)
4. Homeowners' Property Tax Relief Subventions ($442.5 million)
5. Subventions for Open Space / Williamson Act ($38.6 million)

Subventions to offset local revenue loss from the Homeowners' Property Tax Relief program are constitutionally required, and therefore the Governor does not propose to reduce it. The Governor proposes that the remaining four programs each receive a 10-percent budget cut to save $25.5 million (General Fund). The proposed cuts to homeowners/renters programs are outlined in issue #1, and the proposed cut to the Williamson Act subventions is discussed in issue #2.

ISSUE 1: SENIOR HOMEOWNERS AND RENTERS PROGRAMS

The Governor's Budget includes a 10-percent reduction ($21.6 million) to the three homeowners/renters tax relief programs. The reductions are proposed as proportional cuts, so each recipient would see their payment fall by 10 percent. These changes all require legislation.

BACKGROUND

- ***Senior Citizens' Property Tax Assistance*** – provides income-based payments to homeowners with household incomes below $42,770 who are over 62, disabled, or blind. The maximum annual grant is currently $473. The proposed 10-percent would result in General Fund savings of $4.1 million.

- ***Senior Citizens' Property Tax Deferral Program*** – allows homeowners with annual household incomes below $35,500, and who are at least 62 years old, blind, or disabled, to postpone their property tax payments. The state makes the property tax payments on the homeowners' behalf, and is reimbursed when the home is sold, or the qualifying occupants cease their residency. The proposed 10-percent would result in General Fund savings of $2.6 million.

- ***Senior Citizen Renters' Tax Assistance Program*** - provides income-based payments to renters with household incomes below $42,770 who are over 62, disabled, or blind. The maximum annual grant is currently $348. The proposed 10-percent would result in General Fund savings of $15.0 million.

LAO Alternative

In the *Analysis of the 2008-09 Budget Bill*, LAO recommends rejection of the Governor's 10-percent across-the-board approach and instead recommends an alternative that results in similar budget savings, but shifts the impacts away from the lowest-income taxpayers. To illustrate their criticism of the Governor's proposal, the LAO indicates that under the Administration plan the average homeowner with an income of $40,000 would see his or her payment reduced by $2, but a renter with an income of $10,000 would have his or her payment reduced by $35. The LAO recommends that the Renters' Program and Property Tax Deferral Programs be left whole, and instead the Property Tax Assistance program income limits be rolled back from $42,800 to $33,000. This would result in savings of $18.5 million (versus the $21.6 million in the Governor's Proposal).

COMMENTS

- If the Legislature determines that cuts in this area of the magnitude of $20 million are necessary, the LAO's approach appears to be preferable to the Administration's, since the reductions would affect only homeowners with higher (although still very modest) incomes. However, there are other variations on this theme that could be evaluated:

  - One alternative would be to roll back the income ceilings in both the homeowners' and renters' programs. This could be done either to generate the same savings for each program as proposed by the governor (resulting in different income limits for the two programs) or by setting a uniform new income limit (resulting in some shift of the savings between the two programs).

  - The Franchise Tax Board should advise the subcommittee as to the income levels and allocation of savings that would result from these alternative approaches.

- The Subcommittee may want to hold this issue open, pending a reassessment of the state's fiscal situation at the time of the May Revision.

ISSUE 2: OPEN-SPACE SUBVENTIONS

The Administration requests a 10-percent budget reduction ($3.9 million) to Williamson Act Open-Space subventions. The Williamson Act allows cities and counties to enter into contracts with landowners to restrict certain property to open space and agricultural uses. In return for these restrictions, the property owners pay reduced property taxes because the land is assessed at its agricultural or open-space value rather than its normal Proposition 13 value. The State then *partially* compensates the local governments (primarily counties) for their related property tax loss. However, the state cost of the program probably is on the order of twice the $38.6 million for subventions (before the 10 percent reduction). This is because the state automatically backfills school and community college districts for their revenue losses under Proposition 98. The Administration reduction proposal would lower payments to cities and counties, but would not restrict new Williamson Act contracts between property owners and local governments.

LAO Alternative

In the *Analysis of the 2008-09 Budget Bill*, the Legislative Analyst recommends approval of the 10 percent reduction proposed by the Governor, but also recommends that the program be phased out by not allowing any new contracts. Budget savings would increase annually as contracts expire until the program is fully phased out in 10 years. The LAO indicates that the Williamson Act is not a cost-effective land conservation program because in many cases it subsidizes landowners for behavior they would have taken regardless.

COMMENTS

The original purpose of the Williamson Act was to counteract the pressure to sell land for development that resulted as property taxes on farmland near urban areas increased due to market value reassessment. However, that type of selling pressure greatly diminished after Proposition 13 limited assessment growth to 2 percent annually, except for changes of ownership and new construction.