AGENDA
ASSEMBLY BUDGET SUBCOMMITTEE NO. 4 ON STATE ADMINISTRATION

Assemblymember Rudy Bermudez, Chair

WEDNESDAY, MARCH 29, 2006 1:30 PM
STATE CAPITOL, ROOM 437

CONSENT ITEMS

VOTE ONLY ITEMS

ITEMS TO BE HEARD

CONSENT ITEMS

ITEM 8120 COMMISSION ON PEACE OFFICER STANDARDS & TRAINING

ISSUE 1: WEB-BASED TRAINING

POST is responsible for the standards and training of more than 90,000 California law enforcement professionals at the state and local level. In April 2004, the Commission on Peace Officers Standards & Training (POST) sought to increase the accessibility of distance learning by creating the Learning Portal (a web site dedicated to training, courses and collaboration between law enforcement practitioners).

POST is seeking to expand it usage of the Learning Portal by converting four CD-ROM courses into Web-based courses: HazMat Awareness: First Responder; Law Enforcement First Aid/CPR; Drug Identification and the Law; and Drug Influence and User Identification. According to the Commission, these courses are outdated and must be revised. By utilizing web-based programming, POST can reduce production cost and increase access to the information. Accordingly, they request **$350,000 (Peace Officer Training Fund)** for the development of training and performance tools.

ITEM 9100 TAX RELIEF

California taxpayers benefit from a variety of tax relief programs that are funded as expenditures in the budget. Tax relief is provided by the state directly to low-income senior citizens and disabled persons. Property tax relief also is provided to individuals who agree to hold their land as open space under the Williamson Act of 1965, as well as under the Homeowners' Exemption and the Senior Citizens' Property Tax Deferral Program. This budget includes payments to local governments to offset (either fully or partially) these property tax revenue loses.

Governor's Budget 2006-07
Tax Relief
General Fund
(in thousands)

Program	Actual 2004-05*	Estimated 2005-06*	Proposed 2006-07*	Percentage Change
Senior Citizens' Property Tax Assistance	$39,550	$38,632	$38,632	0.0%
Senior Citizens' Property Tax Deferral Program	11,900	12,300	12,800	4.1%
Senior Citizen Renters' Tax Assistance	143,685	137,842	137,842	--
Homeowners' Property Tax Relief	431,065	436,000	442,540	1.5%
Subventions for Open Space	39,209	39,370	39,606	0.6%
Total Expenditures (All Programs)	**$665,409**	**$664,144**	**$671,420**	**1.1%**

The Governor's Budget includes a net reduction of $11.3 million General Fund in the current year, and $3.9 million General Fund in the budget year, for adjustments to reflect estimated participation in the Senior Citizens' Property Tax and Renters' Tax Assistance Programs, the Senior Citizens' Property Tax Deferral Program, and the Homeowners' Property Tax Relief.

ITEMS TO BE HEARD

ITEM 0552 OFFICE OF THE INSPECTOR GENERAL

ISSUE 1: POSITION RECLASSIFICATION

The Office of the Inspector General is requesting the reclassification of 5.8 positions to better align staff with organizational functions. The reclassifications are concentrated in the Bureau of Independent Review, due to the Office's realization that the type and complexity of the investigations they monitor require far more legal training and research than originally anticipated. Specifically, the proposal seeks to:

- Convert 4.8 Deputy Inspector General (DIG) Positions to 4.0 Special Assistant Inspector General (SAI) Positions,
- Redirect $67,000 to overtime, and
- Reclassify an Associate Governmental Program Analyst position to a Staff Services Manger II.

According to the OIG, the proposal seeks to reclassify vacant positions within the office, with no net impact to the General Fund. However, concerns have been raised regarding the amount of overtime requested. OIG believes they have yet to reach their appropriate staffing level. A rough OIG analysis suggests that the office's workload could possibly warrant the addition of eight (8) new positions. OIG is not requesting the additional positions, however, because they are still in the process of filling vacancies and obtaining caseload. They assert that the availability of overtime funds (.75 of a DIG position) would allow budgeted staff to maintain and slightly increase their present caseload.

ITEM 1730 FRANCHISE TAX BOARD

The Franchise Tax Board (FTB) consists of the State Controller, the Chair of the State Board of Equalization (BOE), and the Director of Finance. The FTB administers the Personal Income Tax and the Corporation Tax. FTB also assists other departments and programs in the collection of delinquent debts, including delinquent child support payments (in cooperation with the Department of Child Support Services). The budget proposes total spending of $662 million ($499 million General Fund) and 5,160 personnel-years (PYs) of staff for support of the FTB in fiscal year 2006-07. As shown in Table 1, total proposed spending declines by $34.5 million (5 percent) from the current year, including a General Fund spending reduction of $14.8 million (2.9 percent). Staffing is essentially flat from the current year. The overall spending decrease primarily reflects a $33.8 million decline in funding for development and initial implementation of the Child Support Enforcement System, which reflects the planned spending needs of that program in 2006-07.

Table 1
Franchise Tax Board
Budgeted Expenditures by Program
(in thousands)

Program	Actual 2004-05	Estimated 2005-06	Proposed 2006-07
Tax Programs	$408,123	$421,747	$418,614
Homeowners and Renters Assistance	4,366	5,787	5,789
Political Reform Audit	1,398	1,523	-
Child Support Collections	13,148	-	-
Child Support Automation	147,011	236,720	202,879
Department of Motor Vehicles Collections Program	5,178	5,722	5,803
Court Collection Program	5,752	6,045	9,933
Contract Work	4,620	12,088	12,155
Administration	23,040	23,051	23,051
Distributed Administration	-23,040	-23,051	-23,051
Lease Revenue Bond Payments	7,270	7,267	7,242
Total Expenditures (All Programs)	**$596,866**	**$696,899**	**$662,415**

STAFF COMMENT

Tax Gap and tax agency data systems coordination will be addressed at a subsequent hearing.

ISSUE 1: CHILD AND DEPENDENT CARE EXPENSE CREDIT (CDCEC)

The Legislative Analyst's Office (LAO) notes that the FTB has identified a growing problem of fraudulent claims for the Child and Dependent Care Expense Credit (CDCEC). Although the actual amount of fraud is unknown, the FTB indicates that the dollar amount of fraudulent claims detected increased from less than $1 million in 2001 to close to an estimated $12 million in 2004. Similarly, the average amount of fraud per fraudulent return increased from $425 to $588 during the period. The FTB estimates there will be a total of $51 million in fraudulent claims over the next three years -- an annual average of $17 million.

How the Credit Works. In order to qualify for the CDCEC, an individual or couple (if filing jointly) must incur un-reimbursed expenses for the care of a qualifying child or other dependent in order to earn income or look for work. The California credit is calculated as a percentage of a similar federal credit. Both credits decline as taxpayer adjusted gross income (AGI) increases. Qualifying costs for care are capped at $3,000 for one dependent and $6,000 for two or more dependents. As shown in Table 2, the maximum credit for families with at least two children or dependents ranges from $1,050 for lower-income taxpayers to $408 for those with incomes of between $70,000 and $100,000. Unlike the federal credit, the California credit is *refundable*. Thus, taxpayers without a tax liability can claim the credit and get a refund check. For 2005, a family of four generally pays no California personal income tax if their income is less than about $42,600. Taxpayers with somewhat higher incomes may use the CDCEC to offset their tax liability and they receive a refund for any excess credit amount. The Department of Finance estimates that the CDCEC will cost $225 million for 2005-06, of which the refundable portion will be $189 million (84 percent).

Table 2
Child and Dependent Care Expenses Credits
Maximum Credits for 2005 by Adjusted Gross Income (AGI)
(at least 2 dependents and $6,000 in costs)

AGI	Maximum Federal Credit (nonrefundable)	Maximum California Credit (refundable)	Total Maximum Credit
$ 15,000	$ 2,100	$ 1,050	$ 3,150
30,000	1,620	810	2,430
40,000	1,320	568	1,888
70,000	1,200	408	1,608
100,000	1,200	-	1,200

Many taxpayers who qualify for the CDCEC also qualify for the federal Earned Income Tax Credit (EITC). This is a refundable federal credit of up to $4,400 available to families with AGI up to $37,263 (and to lower-income workers without children).

Refundable Credits Play a Crucial Role, but Pose Special Challenges. The California CDCEC and the federal EITC provide a significant amount of income support to lower-income working families. Absent the refundable aspect of these programs, most families would get little or no benefit from these credits because their incomes are too low to have much income tax liability. Nevertheless, these families do pay a significant amount of payroll taxes on their wages (primarily for Social Security and Medicare). However, the CDCEC has a significant potential for fraud because the refunds are like cash payments—they are not limited to amounts already withheld—and because the eligible group includes many people who may not already be known to FTB because they normally don't have to file. This makes it tempting for scammers to file fraudulent claims, pocket the money, and disappear. Recovering improper payments after the fact can be difficult even in cases where there was only error and not fraud because of the low incomes of the claimants and tenuous connection with the tax system.

In 2005-06, the FTB is devoting 43 personnel-years (PYs) to the administration of the CDCEC. Most of these resources (33 PYs) are devoted to fraud detection. This more than doubles the staffing for fraud detection deployed by the board in 2004-05. The FTB also indicates that its fraud efforts focus primarily on refundable claims and detecting tax preparers who appear to be facilitating large numbers of fraudulent claims.

LAO Recommendations. In view of the fraud problems that have been associated with the CDCEC, the LAO recommends that the Legislature direct the FTB to:

1. ***Report on Its Anti-Fraud Efforts**.* The FTB should report on the impact of targeting its fraud efforts to focus on all areas of fraud prevalence, including the refundable and nonrefundable portions of the credit.

2. ***Require Additional Documentation.*** To preserve the fairness and integrity of the tax credit program, we recommend that the Legislature direct FTB to require additional documentation from taxpayers in order for them to qualify for the credit. LAO further recommends that FTB report at budget hearings regarding the costs and revenues associated with additional documentation options.

COMMENTS

1. **Could the FTB Do a Better Job of Prescreening Claims?** Enforcement against fraudulent tax preparers is appropriate, but it does not necessarily result in recovery of overpayments. Also, unscrupulous tax preparers may circumvent this approach by operating "underground" without identifying themselves as the preparer on the tax form. Furthermore, FTB currently delays payment of CDCEC claims filed by suspect preparers, which also delays payments to legitimate claimants that happen to use those preparers. Better prescreening might be more effective. In addition to addressing the LAO recommendations, the FTB

should address the feasibility of using better prescreening strategies, such as the following:

a. Verifying the Social Security Numbers of the claimants and their children.

b. Verifying the taxpayer identification number of the care provider.

c. Cross-matching CDCEC claims against federal tax returns, including those for the EITC.

ISSUE 2: ENTERPRISE ZONE CREDITS

Enterprise Zones (EZs) and other similar economic incentive zones offer significant tax incentives to businesses that invest in areas with depressed economies and high unemployment. Together, these tax incentives constitute one of the state's largest business tax incentives. A significant number of EZs are set to expire over the next several years. The Assembly Committee on Jobs, Economic Development and the Economy and the Committee on Revenue and Taxation have held an extensive series of joint hearings over the last several months to review these programs. SB 1008 (Ducheny), one of the current bills that would revise the EZ program and potentially extend the life of some of the zones, is set for hearing on April 18th in the Committee on Jobs, Economic Development and the Economy.

BACKGROUND

Origins of Enterprise Zone Incentives. Since the 1980s, tax incentives are available to businesses expanding or locating in particular areas of the state that have been designated as:

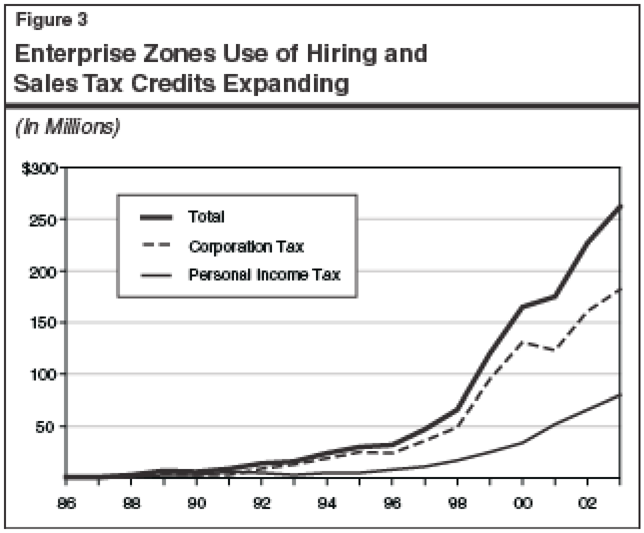
- Enterprise Zones (EZs).
- Manufacturing Enhancement Areas (MEAs).
- Targeted Tax Areas (TTAs).
- Local Military Base Recovery Areas (LAMBRAs).

While the exact characteristics of these designated areas vary somewhat, in general, they were selected due to the challenging socio-economic characteristics that prevailed at the time of their establishment. The EZs were established in 1984, the MEAs and TTAs in 1988, and the LAMBRAs in 1993. Until the program expired, the state also had Los Angeles Revitalization Zone designated areas as well.

The programs are intended to generate additional economic activity through the creation of new employment opportunities. The programs are also intended to create incentives for businesses to hire hard-to-employ individuals who might otherwise be unemployed.

The EZ program is the largest. There are currently 42 separate EZs with 56 separate locations in California. In 2006, 18 of these EZs will expire unless their designated status is renewed. Another 13 expire in 2007 and 2008. The remaining 11 expire between 2009 and 2012.

Usage of Programs Has Expanded. The LAO points out that the use of the various incentive programs has expanded substantially since they were first started. Ten years ago, the total tax incentives claimed for all programs were in the low tens of millions of dollars; however, by tax year 2003, the direct revenue loss to the state had grown to $318 million (as shown in the LAO figure below).



In terms of direct revenue losses, the EZ business tax incentives are the state's second largest--after the research and development tax credit.

Effectiveness of EZs May be Limited. The LAO has reported that most research indicates that these types of incentives have little impact on the overall statewide level of economic activity or employment. However, the research also indicates that geographically based tax incentives can have an impact on the *distribution* of economic activity. Such influence on the location of economic activity is likely to decline as the size of the area increases.

State Needs to Step In. The hiring credit associated with the EZ designation is a program that relies on state and local cooperation and coordination. Direct administration of each EZ is under a local entity. These entities issue vouchers to businesses that hire qualified employees. Each hiring voucher can result in up to approximately $35,000 of tax benefit (over several years) for the business filing the application. At the state level, FTB, the Employment Development Department (EDD), and the Department of Housing and Community Development (HCD) are all involved in some aspects of the program. For example, EDD maintains much of the data regarding the eligibility status of prospective employees, while HCD provides general oversight of the EZs and conducts programmatic audits. The FTB is responsible for reviewing the tax returns of employers claiming the credit and for conducting any appropriate audit activity. These overlapping roles, responsibilities, and authorities have resulted in confusion and muddied accountability.

In particular, FTB has examined the documentation for certain vouchered employees and found that there were significant violations of eligibility requirements. Although the taxpayer challenged FTB's authority to "look behind" the voucher, the State Board of Equalization (the agency responsible for income tax appeals) has affirmed FTB's authority (in a recent decision that is not yet final). Given the level of tax credits claimed-as well as a substantial carryover of earned but unclaimed credits, the BOE decision could result in a significant increase in audit and other compliance-related activities by FTB. These would relate not only to employee eligibility, but also to the location of the employer, the proportion of employee activities carried out in the EZ, as well as other statutory requirements of the program.

LAO Recommendation. Given the magnitude of the revenue impacts of the EZ hiring credit, the administrative issues that have emerged, and the likelihood that the program will continue in some form, LAO recommends that the FTB report at budget hearings regarding the following:

- The current level of audit activity of tax credit claims,
- The level of anticipated audit-related workload activities in the future,
- The adequacy of current audit resources available for funding these activities.

COMMENTS

The FTB also should report to the subcommittee regarding the following issues, especially in light of current legislative efforts to reform the EZ programs:

1. What are the major types of audit issues encountered so far?
2. Does FTB have effective means of verifying the eligibility of employees independent of the voucher? What information needs to be included in the voucher?
3. How should the vouchering process be revised to protect the integrity of the tax system along with reasonable certainty to businesses?
4. What comments has FTB provided to HCD regarding the proposed new EZ regulations?

ISSUE 3: SAVINGS FROM ELECTRONIC PROCESSING

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, he 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.

Will Savings Be Needed to Offset Reductions? The FTB experienced an ongoing $7.8 million unallocated reduction in the 2005-06 Budget and faces potential additional cuts of similar magnitude if the Legislature approves proposed Control Section 3.45 ($58 million General Fund savings from a one percent reduction in personnel) and Control Section 4.05 (an additional $100 million General Fund unallocated reduction). The proposed language of those control sections does not exempt revenue-generating agencies from the cuts or prohibit cuts that would reduce revenue.

COMMENTS

The FTB and the Department of Finance should address the potential impact of additional unallocated reductions on the FTB's current and future revenue-generating functions and on its ability to provide taxpayer services.

ISSUE 4: AUDITOR RECRUITMENT AND RETENTION

The FTB indicates that about 11 percent of its audit positions are not filled, and that it is having difficulties retaining experienced auditors. The need for a qualified, experienced, and stable audit staff is especially important given the complexity of many of the business tax audits (including identifying abusive tax shelters) and the time that they require.

COMMENTS

The FTB should provide the subcommittee with the following information:

1. What are the reasons for the high vacancy rate?

2. What is FTB's plan for reducing the vacancy rate?

3. What effect will these vacancies have on revenues and salary savings in the current year and 2006-07?

ISSUE 5: UNREPORTED TAXABLE EMPLOYEE BENEFITS

In its recently released annual report on improper activities by state employees, the Bureau of State Audits found that the Department of Fish and Game and 13 other state departments that own employee housing may be underreporting or failing to report housing fringe benefits. When departments charge employees living on state property a rate below the fair market value, they must report to the State Controller's Office the difference between the rate charged and the fair market value as a taxable fringe benefit; however, they often failed to do so for all of its employees across the State. As a result, state and federal tax authorities were not notified that taxes were due on potential housing fringe benefits totaling almost $3.5 million for tax years 2002 through 2005 for the Department of Fish and Game alone.

COMMENTS

The FTB should describe its approach to identifying and collecting tax on unreported taxable employee benefits provided to both government and private-sector employees.

The Department of Finance should describe state policies and procedures to ensure the appropriate reporting of taxable benefits.

ISSUE 6: OTHER BUDGET CHANGE PROPOSALS--CONSENT

The FTB budget request includes the following additional budget change proposals. No issues have been raised regarding these proposals, and they are proposed for approval on consent:

- **Out-of-State Legal Counsel.** The Governor's budget requests $694,000 from the General Fund and 1.4 PYs for the FTB to contract with outside counsel to represent the Board in out-of-state bankruptcy cases. The budget indicates that the Attorney General previously performed this function, but has indicated that he no longer has resources for this purpose.

- **Court-Ordered Debt Collection Program.** The Governor's budget requests $3.8 million (special fund) and 29.6 PYs to expand the Court Ordered Debt Collection Program to serve all 58 counties, consistent with the direction in SB 246 (Escutia) of 2004.

- **California Child Support Automation System.** The budget proposes to reduce funding for the California Child Support Automation System by $33.8 million, in accordance with the latest special project report. Adjustments to the schedule include reductions in printing, training, consulting, data processing and equipment, offset slightly by an increase costs to the wide area network. The department is in the third year of system development in a multi-year project expected to be fully implemented in 2010. Chapter 479, Statutes of 1999 (AB 150) directed the FTB to serve as an agent of the Department of Child Support Services to be responsible for procuring, developing, implementing, and maintaining the operation of the CCSAS statewide.

- **Voluntary Contributions.** The FTB requests $18,000 General Fund to pay for the costs of printing and processing the newest tax-check off programs: the Veteran's Quality of Life Fund, California Sexual Violence Victims Services Fund, and California Colorectal Cancer Prevention Fund.

- **Processing Equipment Replacement.** The budget requests $420,000 in the budget year and four years following to finance replacement of a bar code reader and mail sorting equipment that have reached the end of their service lives. The bar code machine allows the FTB to receive discounted postage rates, resulting in a savings of $1.5 million annually. The sorting equipment read, fold, cut, and insert the majority of the department's correspondence

ITEM 1870 VICTIM COMPENSATION & GOVERNMENTAL CLAIMS BOARD

The VCGCB consists of three members: the Secretary of the State and Consumer Services Agency who serves as the chair, the State Controller, and a public member appointed by the Governor. The primary objectives of the California Victim Compensation and Government Claims Board are to compensate victims of violent crime for certain financial losses; settle civil claims against the state in an equitable manner; provide equitable travel allowances to certain state government officials; respond to bid protests against the state; and provide for reimbursement of counties' expenditures for special elections.

ISSUE 1: CRIMINAL RESTITUTION COMPACTS

VCGCB began utilizing Criminal Restitution Compacts (CRC) in fiscal year 1997-98 to facilitate and ensure that restitution is ordered to the VCGCB in those cases where victims have received benefits for the Victims Compensation Program. The goal of CRC is to ensure every identified offender associated with a VCP claim has an imposed, commensurate restitution fine and order imposed.

In October 2004, the Board completed a study to determine the cost benefit of the CRC contracts. The study data supports the effectiveness of the CRC in obtaining restitution. In short, in the CRC counties (21), the courts imposed restitution order in 77 percent of the cases versus 74 percent of the cases in non-CRC counties. Likewise, the courts imposed restitution fines in 90 percent of the cases in CRC counties versus 74 percent of the cases in non-CRC counties.

VCGCB seeks an augmentation of **$607,000 (Restitution Fund**) to expand CRCs to four additional counties: Merced, Riverside, San Joaquin and Tulare. But the program itself will be expanded to nine counties because the San Joaquin CRC is slated to serve five neighboring counties whose workload is too small to justify separate CRCs.

ISSUE 2: COMPENSATION AND RESTITUATION SYSTEM

The Compensation and Restitution System is a federally funded project that allows web-based technologies to better manage VCGCB workload. The second phase of the projected was scheduled for completion in January of 2005, but due to unanticipated circumstances, the completion date has been extended to June 30, 2006.

The Board is requesting to update the budget year expenditure authority necessary for ongoing Compensation and Restitution System (CaRES) project cost. Specifically, they seek budget year federal funding authority of $1.2 million for existing staff, ongoing maintenance, and data center services.

ISSUE 3: OVERHEAD COST AUGMENTATION--CONSENT ITEM

The Government Claims Program resolves claims filed against the State of California alleging legal liability on the part of the State as well as claims requesting equitable relief for State actions where there is no remedy at law. The Program also administers special programs that provide financial relief for citizens impacted by natural disasters or state action.

In 2004 the Government Claims Program became a self-supported program, due to its 100% reimbursements from filing fees and surcharges. However, the Victim Compensation & Governmental Claims Board (VCGCB) asserts that the appropriation level from the reimbursement is insufficient to fully cover the cost of administering the program. Functions such as accounting, legal, and clerical support, as well as equipment and operating cost, are disproportionately funded by the Restitution Fund. Accordingly, VCGCB requests an ongoing augmentation of $334,929 in its Reimbursement appropriation to fully cover administrative overhead cost.

ISSUE 4: JOINT POWER AUGMENTATION—VOTE ONLY

Upon submitting this Budget Change Proposal to the Legislature, the Board and the Department of Finance recognized that the Board's baseline adjustment provided incremental increases to support growth in Joint Power counties. However, the Board believes that there is sufficient data to warrant additional resources to further compensate counties for providing satellite operations for the Board. Accordingly, the Board wishes to withdraw this proposal and be allowed to submit a new proposal during the May revise to justify an additional increase.