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

Assemblymember Juan Arambula, Chair

TUESDAY, MAY 12, 2009 UPON ADJOURNMENT OF JOINT HEARING WITH SUBCOMMITTEE NO. 5
STATE CAPITOL, ROOM 447

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ITEMS ON CONSENT

ITEM 0840 STATE CONTROLLER

Unclaimed Property System Replacement Project—April Finance Letter. The Department of Finance (DOF) requests that the budget for the State Controller’s Office (SCO) budget be reduced by $224,000 (Unclaimed Property Fund—UPF) and 2.6 positions in 2009-10 and an additional $140,000 (UPF) and 2.3 positions in 2010-11, consistent with adjustments to the most recent Special Project Report (SPR 3). The previous SPR 2 anticipated 2009-10 project savings that were $668,400 (and 8.6 positions) greater than those the Governor proposes to “score” with this requested reduction. However, the enactment of Chapter 179, Statutes of 2007 (the General Government trailer bill to the Budget Act of 2007) placed new requirements on the Unclaimed Property System, and this request reflects those additional costs (i.e., unachievable savings). No issues have been raised concerning this request.

ITEM 0950 STATE TREASURER

Technical Correction to Veto—April Finance Letter. The State Treasurer’s Office (STO), a constitutionally established office, provides banking services for state government with goals to minimize interest and debt 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. In signing the 2009 Budget Act, the Governor reduced the Treasurer's budget by $825,000, of which $578,000 was a General Fund reduction, in order to impose savings equivalent to the amount that would be achieved under the Executive Order imposing furloughs on state employees in departments on the basis of employee equity since the Treasurer had declined to implement the furlough order. However, the veto allocated all of the reduction to the Treasurer's General Fund appropriation (which constitutes less than a fifth of the Treasurer's Office support) and to the Central Service Cost Recovery Fund. Most of the Treasurer's support is provided by reimbursements from bond programs. The Finance Letter requests a technical change to correct the allocation of the veto among fund sources. This request does not change the Treasurer's overall budget. It restores $426,000 of (General Fund) and $194,000 (Central Service Cost Recovery Fund) and reduces the amount from reimbursements by an offsetting $620,000.
ITEM 9840  AUGMENTATION FOR CONTINGENCIES OR EMERGENCIES

Technical Language Change Requested by Department of Finance. This budget item provides additional expenditure authority to be used to supplement departments’ appropriations that are insufficient due to unanticipated expenses or emergency situations. There are three separate appropriations, one for each fund type—General Fund (proposed at $44.1 million), special funds ($15.0 million), and other unallocated non-governmental cost funds ($15.0 million). No department augmentation can be made until 30 days after notification in writing to the Joint Legislative Budget Committee. Identical funding was approved by the Legislature with the 2008 Budget Act.

The Administration requests a technical change to Provision 7 of Item 9840-001-0001. This change clarifies that the augmentation dollar and percentage limitations apply to the amount actually appropriated in the item to be augmented instead of the amounts scheduled within the item, which often include amounts appropriated from other funds that are then scheduled in a department's General Fund item. This revised language was developed in consultation with the Legislative Analyst and legislative staff, and no concerns have been raised.

7. For any transfer of funds pursuant to this item, the augmentation of a General Fund item of appropriation made by this act shall not exceed the following during any fiscal year:

(a) 30 percent of the amount scheduled, for those scheduled amounts appropriated, for those appropriations made by this act that are $4,000,000 or less.

(b) 20 percent of the amount scheduled, for those scheduled amounts appropriated, for those appropriations made by this act that are more than $4,000,000.
ITEMS TO BE HEARD

ITEM 0860  STATE BOARD OF EQUALIZATION

The Subcommittee held its first hearing on the State Board of Equalization (BOE) on March 10. The issues presented today include follow-up on selected issues from that hearing; tax administration recommendations by the Legislative Analyst's Office (LAO); and April Finance Letter requests from the administration.

ISSUE 1: MINIMIZING REVENUE LOSS FROM VETO/FURLOUGH SAVINGS

The Subcommittee discussed on March 10 the impact of the Governor's $13.5 million veto (imposing savings equivalent to the amount that would be achieved under his furlough policy) and requested additional information concerning ways to achieve savings while minimizing revenue loss.

Information from BOE. According to BOE staff, implementation of a one-day-per-month self-directed furlough—as provided in the pending Service Employees' International Union (SEIU) bargaining agreement—could result in the loss or deferral of up to $88 million of revenue, of which $52 million would be General Fund revenue, by reducing staff time available for tax administration, audits, and collections. Overall, this reflects a loss or deferral of about $6.50 of total revenue for each dollar of total savings—and a loss or deferral of about $5.25 of General Fund revenue for each dollar of General Fund savings. This estimate is an upper bound and assumes that employees do not use any of their furlough days in lieu of other leave, such as banking some additional vacation time (which would result in costs in future years). The actual loss/deferral will be less. However, BOE contends that under it has little management authority to control usage of employee leave, and has no experience at this time on which to base projections, since (unlike the Franchise Tax Board) it did not implement the Governor's furlough order.

It should be noted that the loss or deferral of special fund revenue also is of concern. These would include local government sales tax revenues, as well as gasoline tax revenues that support transportation programs. In addition to adversely impacting those programs, loss or deferral of state special fund revenues would impact the General Fund by reducing balances available for cash-flow borrowing.
COMMENTS

- Given the extremely critical budget and cash situation faced by the state, it would seem that BOE management should take a more active role in managing staff resources to ensure that revenue losses and deferrals are minimized.

- In addition to actively working with employees to manage vacation use, other options might include the use of additional overtime or hiring additional staff on a temporary basis. BOE should explain more fully how it will minimize revenue losses and deferrals.
ISSUE 2: TAXATION OF FLAVORED MALT BEVERAGES

As the subcommittee heard on March 10, the Governor's Budget for 2009-10 included a request for $1.3 million (General Fund) to implement regulations adopted by the board in April 2008 defining Flavored Malt Beverages (FMBs) as alcoholic beverages that (a) use a fermented malt base (as with beer or ale), (b) are treated to remove the malt characteristics, and (c) to which are added flavorings or other ingredients containing distilled alcohol that constitutes at least 0.5 percent of the final beverage's alcohol by volume. FMBs typically are flavored alcoholic drinks that are sold alongside beer and have similar alcohol contents. Under the regulations, FMBs are taxed at the much higher rates that apply to distilled spirits, rather than as beer or wine. The regulations provide for a rebuttable presumption that all alcoholic beverages, other than wine are distilled spirits (including FMBs). Manufacturers may present evidence to rebut the presumption that their beverage contains distilled alcohol and be taxed as beer. The Governor's Budget included $38.3 million of additional General Fund revenue related to this budget request.

Industry Reformulates and Rebuts. Manufacturers of the targeted beverages recently have filed rebuttals with the BOE indicating that they have reformulated their drinks to be below the 0.5 percent distilled alcohol threshold for FMBs. Consequently, BOE is unable to apply the higher tax rates to these beverages.

Budget Action. The funding for this request was removed, without prejudice, in the 2009-10 Budget Act, based on the apparent ineffectiveness of the new FMB regulation. On March 10, the Subcommittee held this issue open pending a revised and downsized BOE proposal.

Revised BOE Request. Given the action of the industry to reformulate their products, BOE has presented an alternative request for $250,000 (General Fund) and one position for laboratory tests to verify the reformulation. This would be done primarily by attempting to verify that the alcohol content of added flavorings is under the threshold. This request, however, has no specific revenue impact and was not included in the April Finance Letter requests by the administration.

COMMENTS

- Although the revised BOE proposal possibly might detect some noncompliance, it seems likely, given the much higher tax rate that would apply to FMBs, that those manufacturers would likely reformulate again. The fundamental weakness of the BOE regulations is that it focuses only the source of the alcohol in FMBs, and not on the FMBs themselves. This is because BOE's regulatory approach must be based on existing alcoholic beverage tax law. In order for differential taxation of FMBs to be truly effective, the Legislature would have to change the law to impose a higher tax on FMBs regardless of the source of their alcohol.
• While BOE might do a small amount of testing using existing resources, the prospect for significant revenues from this effort would not appear to be adequate to justify a budget augmentation, given the current budget situation.
An April Finance Letter requests $570,000 (General Fund) and $1.7 million in reimbursements (from local sales tax revenues) to permanently establish 22.5 positions to perform the increased workload arising from the establishment of 52 additional Special Taxing Jurisdictions (STJ) since 2005-06. An STJ generally has the same boundaries as a city or county and is created by voter approval of a local add-on sales and use tax.

**Background on Special Taxing Jurisdictions.** By law, STJs are required to contract with BOE for administration of the district taxes. BOE indicates there are currently 115 STJs. The high number of STJs increases the complexity of tax returns and audits. Absent the staff increase in this request, BOE would have to redirect staff away from existing audit and collection work negatively impacting the General Fund revenue by approximately $2 million each year. The budget request is funded primarily through reimbursements from the STJs, but also includes some General Fund due to the fact that all taxpayers are registered and file returns based on all taxing jurisdictions, including STJs, and therefore an employee’s work covers both areas.

**LAO Recommendation**

LAO agrees that additional STJs require some additional staffing at BOE, particularly for new workload in Los Angeles County. However, LAO makes the following recommendations:

- Approve half of the positions (11 positions) at a total cost of $1.2 million.
- Increase reimbursements by $1.84 million and reduce currently-budgeted General Fund by $640,000 (delete the $570,000 General Fund augmentation in the Finance Letter and reduce the 2009 Budget Act General Fund appropriation by $640,000).

LAO believes that 11 positions will be adequate to handle new workload. The recommendation would fund BOE’s STJ workload associated with local taxes added since July 1, 2008 – this would cut the requested funding and positions approximately in half. It would require BOE to continue to absorb the base workload from prior years as they did in last year’s budget. Additional adjustments could be made in future years as warranted. Furthermore, LAO points out that the smaller position augmentation, together with the anticipated change in local revenues, will result in a General Fund savings of $640,000 instead of the proposed $570,000 General Fund augmentation. The total impact on the STJs would be a cost of $1.84 million, or about $140,000 more than proposed in the Finance Letter request.
ISSUE 4: DOF LETTER REQUEST--TEMPORARY 1-CENT SALES TAX

This request consists of two changes related to the BOE’s implementation of the temporary 1-cent sales and use tax increase implemented by AB 3 X3 as part of the February 2009-10 budget package. In total, the requests increase General Fund expenditures by $7.3 million in 2009-10 – this is comprised of $6.4 million from the General Fund for administrative cost reallocation and $880,000 General Fund for 13.3 new limited-term positions.

**Cost Allocation Methodology.** Allocating the cost of sales tax administration and collection between the state and local governments is a complex issue that has been contentious at times. The Legislature last addressed the issue in 2007, when it adopted into law one of the methodologies developed by BOE in response to budget supplemental report language. This cost allocation methodology is found in Revenue and Taxation Code Sections 7204.3 and 7273. Under these provisions, BOE allocates administrative costs across various sales tax revenue recipients based primarily on the amount of revenue collected for each level of government (the state, cities and counties, and STJs). The 1-cent tax increase in the state tax rate increases the State’s share of revenue collections and triggers a reallocation of administrative costs for base collection activities. Secondarily, the marginal collections associated with the tax increase are allocated by the revenue formula – so the cost of the 13.3 new positions would be funded by $880,000 General Fund and $342,000 in reimbursements from local tax revenues. These changes are summarized in the table below.

**Fiscal Summary of BOE Finance Letter Request**

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<th>1-cent Sales Tax Increase Administration 2009-10</th>
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<tr>
<td></td>
<td>General Fund</td>
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<td>Reallocation of base BOE admin costs</td>
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<td>BOE Implementation Cost for tax increase</td>
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<tr>
<td>Total General Fund cost</td>
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<td>Net local government cost change</td>
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As the table shows, the overall General Fund impact of the BOE request is a General Fund cost of $6.1 million.

**Basis for Staffing Request.** The BOE indicates that the 13.3 new positions are needed based on their estimate of new workload: (1) 40 additional minutes to complete each audit; (2) 41,000 additional return errors taking an average of 15 minutes to resolve; (3) 72,000 additional calls taking an average of 15 minutes each; and (4) various...
centralized administration costs.

**LAO Recommendation**

LAO has reviewed the request and makes the following recommendations:

- Approve 7 positions (about half of the requested number) for a General Fund savings of $330,000 versus the requested amount.

- Reduce the cost allocation shift from $6.4 million to $5.15 million, for a General Fund savings of $1.288 million versus the Finance Letter request.

**COMMENTS**

The request raises two issues:

1. Should there be an exception to the existing statutory cost-allocation methodology in the case of the temporary sales tax? If the cost allocation were simply handled on a stand-alone basis for the 1-cent temporary tax, the state General Fund cost would be $1.2 million and the local cost would be held harmless. The statutory methodology of allocating collection costs among the state and local entities using revenue shares generally is fair and based on sound methodology. However, in this case, the state tax increase is only temporary and the state is facing critical budget pressures.

2. The second issue is whether the 13.3 new positions are the appropriate staffing for the marginal cost of the new tax, and if the workload is reasonable, should it be absorbed within the existing budget or funded via an augmentation. The subcommittee may want to consider the approach of funding one-time implementation costs (such as new forms or information technology changes), but have the BOE absorb the longer-term workload. Since the longer-term workload is relatively small it should be absorbable within what is already a constantly changing environment with changes in the number of taxpayers, local add-on taxes, etc. For BOE, most of the one-time work has been done in the current year, because the tax increase was effective April 1, 2009. Staff understands the Administration is considering a Section 26.00 Letter to internally shift BOE budget funding from facility funding to cover these one-time costs.
The Subcommittee heard this issue on March 10, and requested BOE and the Department of General Services (DGS) to report back with options to resolve the problems that have plagued this building and the BOE staff located in it.

**Budget Act Relocation Funding.** The 2009 Budget Act includes an augmentation of $5.7 million ($3.3 million General Fund) to relocate about 500 employees from the current Sacramento headquarters building at 450 N Street, including the establishment of 6 permanent positions to handle the relocation and also for leasing and relocation work at other BOE sites. The budget estimates that the annual cost of this proposal will grow to $8.5 million in 2010-11 and subsequent years.

**A History of Problems.** The HQ building has a long, sad, and expensive history of problems. Construction was completed in 1993. The original owner was CalPERS, and the state leased the building on behalf of BOE. The state purchased the building several years ago because financing a purchase appeared more cost-effective than the ongoing lease payments. However, the building has a history of construction defects causing water leakage, mold, and glass falling out of the building curtain wall. A major project to replace the curtain wall glass and seals and to remediate areas of water leakage was completed in 2006. Leakage problems, other building system problems, and employee complaints of building-induced illness continue nevertheless. According to BOE, bond financing for the purchase was never completed due to the ongoing problems and $88 million of temporary financing from the Pooled Money Investment Account remains in place. Compounding this situation, in March of this year, a major hot water pipe burst flooding several floors.

**Occupancy Exceeds Desirable Level.** The BOE indicates that the recommended maximum occupancy for the building is 2,200 and that estimated occupancy will exceed this level by 415 in the current year. The Board indicates that leasing additional space and reducing crowding is necessary to maintain employee productivity and morale and to protect the health and safety of employees because the building’s HVAC and other systems are being stretched and because remediation of ongoing problems requires continually shifting employees out of the areas affected by the remediation work.

**Options Under Consideration**

The $5.7 million appropriated in the 2009 Budget Act is a partial step in resolving issues with the headquarters building. Repairs are needed for water-related damage in many restrooms and for the recent major pipe burst. The multiple problems over multiple years have resulted in calls to perform a more extensive overhall or to sell the building. DGS and BOE both have consultants monitoring the building's air, and DGS expects to have a report soon on the results of a comprehensive building infrastructure study. DGS has provided the following a list of options that are being analyzed for cost and risk:
1. Move BOE out of building, repair when empty, then re-occupy.

2. Repair, while occupied by BOE, utilizing “swing space” within the building where employees are temporarily relocated two floors at a time.

3. Repair floors, while occupied, by sealing off the work areas and directing employees to restrooms and breakrooms on other floors.

4. Sell the building.

Staff understands that BOE and DGS are working together to analyze these options. While selling the building might be appealing, it may be difficult to sell it in its current condition. Any sale that recovered less than the $88 million owed to the PMIA would necessitate repayment of the shortfall—probably from the General Fund.

$5.9 million Available from Unnecessary Debt-Service Funding. The BOE budget includes $5.9 million to pay the cost of bond debt service on the headquarters building even though bonds have not been sold, and there is no prospect of selling bonds any time soon. In the recent past, the BOE has redirected the bond debt-service funding for mold and water mitigation and repair costs. BOE and DGS indicate there are water and mold mitigation costs in 2009-10 that go beyond funds appropriated for that purpose. It seems likely the Administration would again in 2009-10 shift the $5.9 million to building repairs. Given that this is the likelihood, the Subcommittee may want to consider a budget action to correctly budget the $5.9 million as building repairs instead of debt service (this would not amend the budget bill, but rather indicate the adjustment in the Department of Finance Change Book budget tracking system).

Related Staffing Budget Issues. BOE changed their costing for the “Facilities Operations” component (rent cost) of new positions from the $2,819 used last year to $11,351 for new Headquarters positions and $6,040 for new district positions. This new costing is included in new positions approved in the 2009-10 Budget Act and those requested in April Finance Letters. This new costing appears high for either methodology of (1) costing for the actual marginal cost of the new positions, or (2) costing based on the overall average for base and new staff. The higher costing seems instead to be related to the headquarters facility issues that also are addressed in the employee relocation proposal. To the extent that this is the case, a reduction in the Facilities Operations costs of new positions (totaling up to $1.1 million) is warranted. BOE indicates another cross-cutting issue is the amount budgeted for new positions related to workstations. BOE staff reviewed the costing and indicate $7,500 per position was double-counted. Therefore, BOE indicates a budget reduction of $285,000 is necessary to correct for the double-counting. However, this amount will need to be adjusted to reflect Subcommittee actions affecting staffing.
COMMENTS

Problems with the facility are ongoing and costly. At a minimum, they have disrupted BOE operations (potentially reducing state and local revenues), and they also may be causing health problems for some BOE employees. These issues make a comprehensive resolution plan essential. It is not clear, however, that BOE, DGS, and the Department of Finance will be able to develop a comprehensive plan before this spring’s budget process concludes. Solutions also are constrained by the state’s budget and cash problems.

Potential Interim Actions. The Subcommittee could take the following actions at this point:

1. Maintain the $5.7 million already approved in the 2009 Budget Act.

2. Shift the $5.9 million for bond debt service to building repair (this would likely occur anyway through internal redirection).

3. Direct BOE and DOF to adjust the facilities/general expense budgeting for new positions: cut $286,000 for workstation double-counting, and cut $1.1 million for over-budgeted per employee rent costs (these changes would also have to be adjusted to conform with other subcommittee actions affecting new positions).
ITEM 0950 STATE TREASURER

The state Treasurer chairs a number of financing authorities, including the California Pollution Control Financing Authority (CPCFA).

ISSUE 1: CALReUSE--INFORMATIONAL

The Subcommittee has been made aware of a request by the CPCFA for $60 million from Proposition 1C (of 2006) Housing Bond Funds.

CALReUSE. The California Recycle Underutilized Sites Program assists with the reuse and redevelopment of underutilized properties with real or perceived hazardous material contamination issues—brownfields. CALReUSE has two components. The Assessment Program provides forgiveable loans to assist with brownfield site assessments. The Remediation Program provides both grants and loans to lean up brownfields that will be redeveloped into mixed-use and residential developments.

Projects currently seeking CALReUSE financing include, among others, the Railyards (Sacramento), Hunters Point (San Francisco), Napa Pipe (Napa), and Boulevards at South Bay (Carson).

The Proposition 1C funds would come from $850 million provided in that bond act in the Regional Planning, Housing, and Infill Incentive Account, subject to legislative appropriation and any criteria or conditions established by the Legislature in statute. Uses of the account may include "brownfield cleanup that promotes infill housing development and other related infill development consistent with regional and local plans."

COMMENTS

1. The Legislature provided $60 million of Prop. 1C funds for CALReUSE in 2007. An additional $60 million was included in AB 7 X1, a bill amending the 2008 Budget Act, passed by the Legislature in December 2008, but vetoed by the Governor.

2. The Department of Housing and Community Development (HCD) indicates that all of the remaining funds in the Prop. 1C Infill Incentive Account have been appropriated to it in the 2009-10 Budget Act. According to HCD:

   Diverting funds to CalReUSE would directly reduce funds for infill housing development under the Infill Infrastructure Grant Program. On January 30, 2009, HCD released the $197 million NOFA [Notice of Funding Availability] for the Infill Infrastructure Grant Program. We have received about three times that dollar amount in funding requests. Clearly, there are a significant number of projects throughout the state that could, through the Infill Infrastructure Grant Program
should the funding be made available to that program. Further, while environmental remediation is an allowable cost under the Infill Infrastructure Grant Program, costs that fall under CalReUSE eligible costs are not allowable costs under the Infill Infrastructure Grant Program. Therefore, sites that require CalReUSE funding to eventually be developed into housing sites will also likely need state assistance to produce the housing. While it is appropriate to mitigate past environmental damage, the use of the limited housing funding should be prioritized for programs that provide housing unit development as directly and efficiently as possible.

3. CPCFA should address the issues raised by HCD, and clarify whether it is seeking a redirection of funds already appropriated to HCD. Staff notes that the Governor's Budget appears to show a remaining unappropriated balance of $53.7 million in the Infill Incentive Account.

4. Staff notes that this issue was only recently raised. Because CALReUSE is under the CPCFA and CPCFA was not noticed for this hearing, this issue is being heard under the Treasurer, but is informational only.
ITEM 1730  FRANCHISE TAX BOARD

The Subcommittee held its first hearing on the Franchise Tax Board (FTB) on March 10. The issues presented today include follow-up on selected issues from that hearing; tax administration recommendations by the Legislative Analyst’s Office (LAO); and April Finance Letter requests from the administration.

ISSUE 1: MINIMIZING REVENUE LOSS FROM FURLOUGHS

The Subcommittee discussed on March 10 the impact of the Governor's furlough program on FTB operations and requested additional information concerning ways to achieve savings while minimizing revenue loss.

Unlike employees at BOE, FTB employees have been subject to furloughs. The FTB has implemented 2-day-per-month "self-directed" furloughs. However, many FTB employees are represented by bargaining units affiliated with the Service Employees International Union (SEIU), and should a proposed Memorandum of Understanding (MOU) with SEIU be implemented, the furloughs for those employees would fall to 1 day per month. Under the SEIU MOU, employee wages would be reduced by the equivalent of 1 day per month, but employees would have discretion, in cooperation with management, to work a full schedule and take off furlough days at a later time or take furlough days in lieu of vacation (which would be banked for future use). The self-directed furloughs would extend through June 2010. Employees would have until July 1, 2012 to use any deferred furlough days.

Information from FTB. According to FTB staff, the savings under the self-directed furlough policy will be roughly $20 million and would result in the loss/deferral of $30 million to $50 million of revenue (by reducing staff time available for tax administration, audits, and collections). This revenue loss is much less than FTB's original estimate of a loss/deferral of $260 million because FTB's initial experience indicates that employees use much of their furlough time in lieu of normal vacation (February data suggest that at least 75-percent of furlough hours and March data suggest that 51-percent of furlough hours were in lieu of vacation, respectively). Additionally, FTB is implementing other mitigation measures to maintain collection and audit work hours -- these measures include: (1) restricting use of vacation time to low-workload months; (2) increasing production hours by canceling or deferring training and meetings; and (3) increasing production hours by delaying or decreasing special project work and initiatives. Overall, the FTB estimates reflect a loss or deferral of about $1.50 to $2.50 of revenue for each dollar of savings.

Information from the Department of Finance: The Department of Finance (DOF) indicates that, as with BOE, they have not scored any revenue loss from furloughs at FTB, because they believe FTB will be able to manage (and limit if necessary) staff time off.
COMMENTS

- Additional options to minimize the revenue loss/deferral might include the use of overtime or hiring additional staff on a temporary basis. FTB should explain more fully how it will minimize revenue losses and deferrals.

- Although the use of furlough days in lieu of vacation will reduce revenue loss in the near term, the banking of vacation days will result in greater use of vacation time off in subsequent years as well as increased costs to buy out accrued vacation when employees leave state service. Consequently, a significant portion of the negative impacts of the furlough program on state revenues and costs will be shifted into future years. The same is true regarding the deferral of training time and special projects.
ISSUE 2: ENTERPRISE TO DATA REVENUE (EDR) PROJECT

The Subcommittee first heard this issue on March 10. The Governor's Budget requested $3.9 million of funding and 58 positions for this project. However, this request was deleted (without prejudice) in the 2009-10 Budget Act. That action reflected concern that this is the initial request for a major new data integration project at FTB that would cost about $300 million (through 2016-17) to implement and which should be subject to further legislative review. The Subcommittee held this issue open on March 10th.

Finance Letter Request. The Administration has since submitted an April Finance Letter that modifies the proposal by accelerating, from January 2010 to July 2009, the hiring of staff such that the 2009-10 costs increase to $5.2 million. However, the request also increases the 2009-10 General Fund revenue associated with the project from $4 million to $7 million. More importantly, the FTB estimates that the project will generate about $2.8 billion of additional revenue over the project timeline, and that ongoing net revenue would be in excess of $900 million annually.

EDR Budget Proposal and Project Description

As modified by the Finance Letter, the 2009-10 EDR budget proposal consists of $5.2 million (General Fund) and the addition of 58 positions for FTB to: (1) resolve an existing backlog in business entity return processing and collections correspondence; (2) hire additional staff and consultants to document FTB’s business processes as a precursor to development of the EDR Project; and (3) begin planning for the EDR project, including issuing a request for proposals. The FTB estimates that the proposal will increase General Fund revenue collected by $7 million in 2009-10 and by $19.9 million in 2010-11, primarily by adding staff to process the current backlog of business entity returns and begin collection correspondence in order to accelerate revenue. The EDR project would take approximately seven years to implement fully and, once completed, would replace several older FTB information technology systems and streamline other existing systems. The FTB estimates the project will cost a cumulative total of $317 million through 2017–18), with ongoing annual costs thereafter of $13.5 million.

Main Goals. The EDR Project has three major goals. First, it seeks to capture all tax return data in an electronic form. Second, the project will integrate the various existing "siloded" tax databases at FTB into a data warehouse. Third, the project will enable FTB to add third-party data (county assessor data, for example) to its data warehouse. The FTB asserts that the EDR Project will allow it to substantially improve detection of underpayment and fraud in order to collect taxes from those who are not paying the full amount that they owe. In addition, the FTB indicates that the project will enable it to improve service and give taxpayers better access to their tax records.
Project Components. The project includes the following improvements to FTB's systems that process personal income tax (PIT) and business entity tax returns:

- An underpayment modeling process that would be integrated with the Accounts Receivable Collections System and Taxpayer Information System.
- An enterprise data warehouse with data search and analysis tools.
- A taxpayer records folder that is accessible to the taxpayer and allows taxpayers and FTB staff to access the information.
- Re-engineering of existing business processes—including imaging of tax returns, data capture, fraud and underpayment detection, tax return validation, filing enforcement, and other audit processes—and integration of these enhanced business processes with FTB's existing tax systems.
- Improved business services at FTB such as address verification, issuance of notices, and a single internal password sign-on for its IT systems.

Benefit-Funded Approach. FTB indicates that it plans to finance the EDR Project using a benefit-funded approach. Contractor payment for system development and implementation will be conditioned on generating additional revenue that will more than cover the cost. This approach is intended to protect the state and also gives the contractors a strong incentive to develop the project in a manner that produces significant revenue quickly. The FTB has used this approach previously. FTB's benefit-funded approach makes use of revenue gains from reducing the business entity backlog to fully offset costs in 2009-10 through 2012-13. Although these gains could be accomplished regardless of whether project development goes forward, it makes sense to move forward now because cleaning up the backlog is a necessary condition to efficient project development. In subsequent years, the estimates in the project's Feasibility Study Report (FSR) indicate large increases in annual revenue gains that would be more directly attributable to the project. From 2012-13 through 2016-17 annual revenue gains increase from $86.4 million to $940 million, while project implementation costs increase from $58.8 million in 2012-13 to a peak of $111.6 million in 2014-15 and then decline to $14.1 million by 2016-17.

LAO Now Recommends Approval. The LAO originally recommended deferral of this project but has since changed its recommendation to support implementation of the project beginning in 2009-10, as proposed in the Finance Letter request.
1. Because the net benefit of this project (as estimated in the FSR) ramps up quickly and becomes very large, the net present value loss to the General Fund that results from delaying the project by one year is somewhere between $600 million and $900 million (depending on discount rate). The investment required to avoid this loss is about $24 million over the next three years (disregarding revenue from backlog reduction). As noted above, the project begins to produce significant net revenues starting in 2013-14. Of course, these calculations critically depend on the accuracy of both the estimates and the schedules in the FSR.

2. The FTB has, perhaps, the best track record in California state government for the successful development and implementation of major information technology projects. However, FTB projects have experienced some significant delays and cost increases, although these problems generally have not prevented successful completion.

3. Due to the large cost of this project and the large projected revenue benefit, the subcommittee directed FTB, LAO and DOF to develop specific staged reporting requirements for the EDR Project that are designed to keep the Legislature fully informed and to detect any cost overruns, delays, or failure to meet goals on a real-time basis. FTB has proposed the following language:

   **Enterprise Data to Revenue Project (EDR).** The Franchise Tax Board (FTB) shall report to the Joint Legislative Budget Committee and appropriate fiscal and policy committees of the Legislature on the status of key milestones of the EDR project on April 1, 2010, April 1, 2011, and April 1, 2012. Each report shall consist of a detailed description of the following:

   a. Return processing and collections backlog status.
   b. Projected and actual revenue.
   c. System Documentation Tool status.
   d. Selected vendor.
   e. Tasks added or removed from original plan.
   f. Major new issues.

   While helpful, this language fails to provide the real-time reporting of significant events that the subcommittee is seeking. Consequently, it should be modified to add a requirement to report within 30 days of a significant event affecting the scope of the project, project timing, cost, or revenue either in total or as scheduled. The reporting requirement also should include events that potentially would have a significant impact (or threaten to have such an impact)—for example, major vendor disputes or protests.
ISSUE 3: UNNECESSARY FUNDING FOR ADMINISTRATION OF SENIOR HOMEOWNERS AND RENTERS ASSISTANCE PROGRAM

The Subcommittee heard this issue on March 10 and held it open pending additional information from FTB.

The FTB budget includes $6.4 million in the current year and $6.5 million in 2009-10 (all General Fund) for administration of the Senior Homeowners and Renters Assistance Program. This funding supports 79 positions, of which 33 are temporary help. The HRA program provided annual payment to low-income seniors and disabled renters and homeowners. Although the program continues to be authorized in law, the Governor vetoed all funding for payments in the 2008-09 Budget Act, and no funding for payments was included in the Governor's January Budget or in the 2009 Budget Act (SB 1 X3).

FTB Has Identified Savings. The FTB indicates that it continued to include administrative funding in its budget in the event that funding was restored for the assistance payments. The department also indicates that some ongoing administrative work is needed to process claims for prior years, to maintain the existing data systems if any continuation of the program is anticipated, and to continue funding fixed central administrative costs.

If the program suspension is ongoing, the FTB suggests that the budget could be reduced by $4.8 million in 2009-10 and by an additional $500,000 in 2010-11. This would result in the residual funding of $1.6 million in 2009-10 and $1.2 million ongoing for FTB operations. The FTB indicates the retained $1.2 million would be for fixed costs of rent ($600,000) and the HRA share of centralized information technology maintenance ($550,000). The FTB would also request to retain $500,000 and 7 positions for 2009-10 to complete prior-year claims and appeals related to 2007-08 HRA activity.

COMMENT

1. FTB has indicated the current year savings will be $2.9 million.

2. Although it is possible that this program may be restored in some form in the future, maintaining staff for a suspended program a luxury the state cannot afford. The ongoing funding that FTB seeks to retain, however, appears reasonable because it is for fixed costs that are not specific to the HRA Program.
In an April Finance Letter, FTB requests $663,000 (General Fund) and 8 positions in 2009-10 and $145,000 and 1.5 positions ongoing to implement and administer the provisions of SB 15 X2 and SB 15 X3 – two tax credit measures enacted with the February 2009-10 budget package.

Detail on the New Tax Credits. Each of the new tax credits is temporary and has a total credit cap. The credits are as follows:

- **Homebuyer's Credit.** This credit is capped at a total of $100 million and is available for the purchaser of a new home used as their principal residence. Homebuyers receive a state income tax credit of the lesser of 5 percent of the purchase price of the qualified principal residence or $10,000. Credits are allocated by FTB. FTB requests $219,000 and 2.8 positions in 2009-10 for associated workload, with no ongoing costs or positions.

- **Small Business Hiring Credit.** This credit is capped at a total of $400 million and is available as a $3,000 tax credit for each new full-time equivalent employee at a qualified small business. Credits are allocated by FTB. FTB requests $289,000 and 3.2 positions in 2009-10 for associated workload, with $34,000 and 0.5 positions ongoing.

- **Film/Television Production Credit.** This credit is capped at a total of $500 million with no more that $100 million allocated each year for five years. Credits can be allocated starting in the 2009-10 fiscal year, but can only be claimed in tax years beginning in 2011. The Film Commission within the Business, Transportation and Housing Agency is charged with initial allocation of the credits and, upon project completion, certifying qualifying spending and the amount of credit earned. The FTB will have to verify that the taxpayer claiming the credit is in fact the qualified taxpayer allocated credits by the Film Commission or the purchaser or transferee of such credits. FTB requests $154,000 and 2.0 positions in 2009-10 for associated workload, with $111,000 and 1.0 position ongoing.

**FTB Request.** Most of the workload associated with this request is one-time information-technology modifications. Five one-year limited-term Programmer Analyst positions are requested to create new forms, develop a secure transmission process for the receipt of the certifications, make system changes to collect data from the returns upfront, and monitor the allowance of credits. The 1.5 positions ongoing are 1.0 Program Specialist in the audit division (related to the Film/Television Credit) and 0.5 Tax Program Technicians in the Filing Division (related to the Hiring Credit). The ongoing positions would maintain data on credits and answer inquires.

**LAO Recommendation.** LAO recommends approval of $265,000 and 3 positions. LAO agrees that the new tax credits impose additional workload on FTB, but is unconvinced that 8 positions are needed. LAO notes that the Homebuyer's Credit is likely to reach its cap very quickly (at current rates, the $100 million cap will be reached by about July),
and the Film/Television production credit cannot be claimed until 2011. The LAO recommendation would result in a savings of $398,000 and 5 positions versus the FTB request.

**COMMENT**

A significant amount of the workload needed to implement these credits will have occurred in the current year or, in the case of the Film/Television Credit, will not occur until 2010-11 (although FTB currently is working with the Film Commission to develop forms and ensure a consistent approach).
FIRM is an IT project that would require financial institutions doing business in California to match FTB information on delinquent tax and non-tax debtors against their customer records on a quarterly basis. The FTB estimates the annual General Fund revenue gain at $35 million in 2009-10, growing to $101 million by 2011-12. The 2009-10 cost to begin implementation would be $3.2 million and total project cost would be $20.8 million over four years. Last year FIRM was discussed in the Budget Conference Committee—the Department of Finance opposed FIRM, citing no completed Feasibility Study Report (FSR), as is required for new IT projects. The FSR has since been completed, but the Administration has not, to date, proposed the project for the 2009-10 budget.

Background / Detail: FIRM is patterned after the FTB’s Financial Institution Data Match (FIDM), a project FTB implemented as a result of federal legislation to identify the assets of delinquent child support debtors. The success of FIDM prompted FTB to develop an extension of the asset identification effort—via FIRM—to other debtors. The FTB would use the new data to aid in the collection of debts under the authority of the existing Order to Withhold (OTW) statutes. Existing law provides constitutional due process protections and appeal rights available in either the audit or collection processes. FIRM would take about 18 months to implement, so the 2009-10 revenue gain is an accrual gain—on a cash basis, the program would be a net cost in 2009-10. The IT system, as proposed, would only include FTB, but the system could be easily modified after implementation to support debt collection for the Board of Equalization (BOE) and the Employment Development Department (EDD).

Policy Bill on FIRM: SB 402 (Wolk), as amended April 28, 2009, would enact the statutory authority for FIRM, but the bill specifies actual implementation would require an appropriation by the Legislature. The bill includes a provision to reimburse banks up to $2,500 for implementation and up to $250 per quarter thereafter. Staff understands that with this provision, no banks are on record opposing this bill. If SB 402 is enacted this year, but no funding is appropriated for 2009-10, the net General Fund benefits of the program would be delayed.

COMMENT

1. The FTB should present the FIRM proposal and the LAO and Department of Finance should comment.

2. Last year, the Subcommittee approved a placeholder version of FIRM in order to place the proposal in Conference. The Subcommittee may wish to consider taking this action again—the proposal now is further along in development and does present an opportunity to gain significant ongoing revenue by improving collections. One, however, concern would be the cash outlay in 2009-10.
ISSUE 6: LAO TAX ADMINISTRATION AND CONFORMITY PROPOSALS

The LAO Analysis lists 12 options (plus FIRM, which is discussed separately in Issue 5 above) for the Legislature to consider in order to improve revenues through changes in tax administration and/or conformity with federal tax practice. If all the LAO options, excluding FIRM, were adopted, a General Fund revenue gain of $47.6 million would be realized in 2009-10, growing to $77.1 million in 2011-12.

The following LAO table lists the various options. Most of these would apply to FTB, but some apply to the Board of Equalization – Committee Staff has amended the table to indicate the applicable department.

**Tax Administration Reforms and Federal Tax Conformity Recommendations**

(General Fund Benefit, in Millions)

<table>
<thead>
<tr>
<th>Administrative Modifications</th>
<th>2008-09</th>
<th>2009-10</th>
<th>2010-11</th>
<th>2011-12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implement financial institutions records match system (FTB)b</td>
<td>—</td>
<td>$33.0</td>
<td>$61.0</td>
<td>$101.0</td>
</tr>
<tr>
<td>Faster use of liens in collections process (BOE)</td>
<td>—</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Comply with federal withholding requirementc (SCO)</td>
<td>—</td>
<td>—</td>
<td>26.0</td>
<td>1.0</td>
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<td><strong>Subtotals Administrative Modifications</strong></td>
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<td>($34.0)</td>
<td>($88.0)</td>
<td>($103.0)</td>
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<td>Penalty and Interest Modifications</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Penalize “baseless” overstated claims for refunds (FTB)</td>
<td>$0.5</td>
<td>$1.3</td>
<td>$6.2</td>
<td>$12.2</td>
</tr>
<tr>
<td>Extend period before interest is suspended on tax returns (FTB)</td>
<td>1.3</td>
<td>4.0</td>
<td>4.3</td>
<td>4.7</td>
</tr>
<tr>
<td>Increase penalty for failure to file partnership returns (FTB)</td>
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<td>0.9</td>
<td>1.7</td>
<td>1.8</td>
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<td>Assess penalty for failure to file S corporation returns (FTB)</td>
<td>—</td>
<td>0.6</td>
<td>1.0</td>
<td>1.4</td>
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<tr>
<td>Increase penalty for bad checks and money orders (FTB &amp; BOE)</td>
<td>—</td>
<td>0.4</td>
<td>1.0</td>
<td>1.0</td>
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<tr>
<td>Assess penalty if tax preparer understates taxpayer liability (FTB)</td>
<td>—</td>
<td>—</td>
<td>0.3</td>
<td>0.6</td>
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<td><strong>Subtotals Penalty and Interest Modifications</strong></td>
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<td>Fee Modifications</td>
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<tr>
<td>Modify fees for installment agreements (BOE)</td>
<td>—</td>
<td>$4.0</td>
<td>$4.0</td>
<td>$4.0</td>
</tr>
<tr>
<td>Modify and assess fees for offers in compromise (BOE and FTB)</td>
<td>—</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
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<tr>
<td><strong>Subtotals Fee Modifications</strong></td>
<td>(—)</td>
<td>($4.4)</td>
<td>($4.4)</td>
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<td>Federal Tax Conformity Issues</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partially conform to federal backup withholding (FTB)</td>
<td>—</td>
<td>$35.0</td>
<td>$35.0</td>
<td>$38.0</td>
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<td>Conform to the IRS’s “kiddie tax” rules for unearned income (FTB)</td>
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<td>—</td>
<td>15.0</td>
<td>11.0</td>
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<td><strong>Subtotals Federal Tax Conformity Issues</strong></td>
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<td>($35.0)</td>
<td>($50.0)</td>
<td>($49.0)</td>
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<td><strong>Totals</strong>                                    **</td>
<td>$1.8</td>
<td>$80.6</td>
<td>$156.9</td>
<td>$178.1</td>
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</table>

* Revenue estimates assume recommendations are effective January 1, 2010, and are net of implementation costs.
* The FIRM proposal is discussed separately in Issue 5 above.
* Estimate reflects total revenues rather than net revenues.
COMMENT

1. The LAO will provide a handout with descriptions of each of the proposals in the table above (see LAO's 2009-10 Budget Analysis Series, General Government, pp.GG 12-17) and provide the subcommittee with comments on each.

2. Staff understands the administration is still reviewing these options and would come forward in the May Revision with any proposals they support. However, FTB and DOF should provide any comments or response that they have at this time.
ITEM 9620  PAYMENT OF INTEREST ON GENERAL FUND LOANS

This budget item appropriates funds to pay interest costs on anticipated General Fund cash-flow borrowing during the fiscal year. Because receipts and disbursements occur unevenly throughout the fiscal year, the General Fund borrows on a short-term basis in most years, even when the budget is not under unusual stress. Interest is paid on both internal borrowing (cash-flow loans from most special funds) and for external borrowing (selling notes to investors, such as Revenue Anticipation Notes, or RANs). The 2009 Budget Act (SB 1 X3) includes $100 million for interest costs on internal borrowing, and the Governor's Budget assumed $350 million for interest costs on external borrowing. Funding related to internal borrowing is included in the annual budget bill, but funding for external borrowing costs is continuously appropriated in order to reduce risk for borrowers and lower interest costs.

ISSUE 1: APRIL FINANCE LETTER

Additional Interest Costs

After the passage of the 2009-10 Budget, the Department of Finance recalculated cash-flow borrowing and now believes additional borrowing, both internal and external, will be required in 2009-10. The external cash-flow borrowing need for 2009-10 is currently estimated at about $13 billion, which would exceed any past year's borrowing. This higher level of borrowing will result in increased internal borrowing costs of $50 million (to a new total of $150 million) and higher external borrowing costs of $250 million (to a new total of $600 million). Legislative action is needed only for the internal borrowing because external borrowing costs are not limited due to the continuous appropriation.

Amendments to Budget Bill Language

In addition to the augmentation, the administration requests the following revisions to budget bill language (changes are underlined). The amendments would essentially allow funds in the budget item to be used for late payment penalties and Registered Warrant (or "IOU") costs. This would help the State fund costs that would be incurred if the Controller has to again delay payments, and possibly take the additional step of issuing Registered Warrants.

Amendment to 9620-001-0001, Provision 3:

In the event that Revenue Anticipation Warrants (RAWs) or Registered Warrants (IOUs) are issued, or considered to be issued, there is hereby appropriated any amount necessary, in excess of the amount appropriated by this item, to pay the expenses incurred by the Controller, Treasurer, Attorney General, and the Department of Finance in providing for the preparation, sale, issuance,
advertising, legal services, credit enhancement, liquidity facility, or any other act which, as approved by the Department of Finance, is necessary for such issuance. Funds appropriated by this item shall not be expended prior to 30 days after the Department of Finance notifies the Joint Legislative Budget Committee of the amounts necessary or not sooner than such lesser time as the Chairperson of the Joint Legislative Budget Committee may determine.

Addition to 9620-001-0001, new Provision 5

In the event that the Controller must implement a payment delay plan to manage emergency cash needs with the concurrence of Department of Finance, there is hereby appropriated any amount necessary, in excess of the amount appropriated by this item, to pay the interest expenses, late payment penalties, and other costs incurred by the Controller which, as approved by the Department of Finance, are necessary to implement the payment delay plan. Amounts appropriated pursuant to this provision shall be transferred, upon approval of the Department of Finance, to augment Item 0840-001-0001 of this act. Funds appropriated by this item shall not be transferred or expended prior to 30 days after the Department of Finance notifies the Joint Legislative Budget Committee of the amounts necessary or not sooner than such lesser time as the Chairperson of the Joint Legislative Budget Committee may determine.

The phrase shown in strikeout above, is included in the Finance Letter request, but LAO has recommended it be deleted (because it conflicts with the Controller's authority over payments). Staff understands that DOF does not object to the modification.

LAO Update—Cash-Flow Crisis Worsens

On May 7, LAO issued an update to their January report on the state’s cash-flow crisis, which points out that the state's external cash borrowing needs could exceed $20 billion in early 2009-10. Borrowing such a large amount may be impossible given the state's fiscal condition and current conditions in the credit markets. LAO recommends that the Legislature take prompt steps to limit the need for external cash-flow borrowing to $10 billion.

COMMENTS

1. The Administration and the LAO should update the Subcommittee on the cash flow outlook, indicating the anticipated RAN or Revenue Anticipation Warrant (RAW) borrowing need.

2. Staff Notes that the Finance Letter may be subject to significant changes after the May Revision.