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

### Assemblymember Juan Arambula, Chair

PART I

TUESDAY, MAY 22, 2007, 10:00 AM

STATE CAPITOL, ROOM ~~TBA~~4474

### ITEMS ON CONSENT

| ITEM | DESCRIPTION | |
|---|---|---|
| P ~~P1730~~ | ~~Franchise Tax Board~~ | |
| ~~ISSUE 1~~ | ~~CHILD SUPPORT AUTOMATION UPDATE—MAY REVISION~~ | |
| ~~ISSUE 2~~ | ~~VEHICLE REGISTRATION COLLECTION PROGRAM—MAY REVISION~~ | |
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~~1730 FRANCHISE TAX BOARD~~

~~ISSUE 1~~

~~ISSUE 2~~

### ITEMS TO BE HEARD



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# ITEMS ON CONSENT~~TO BE HEARD~~

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## ITEM 1730~~0860~~ ~~S~~FRANCHISE TAX BOARD~~TATE BOARD OF EQUALIZATION~~

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### ISSUE 1: ~~SAVINGS FROM ELECTRONIC FILING~~CHILD SUPPORT AUTOMATION UPDATE—MAY REVISION

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The Franchise Tax Board (FTB) requests an increase of $728,489 in r~~R~~eimbursement authority to support the continued management and implementation of the FTB California Child Support Automation System (CCSAS) Project as reflected in the May 2007 Federal Advanced Planning Document Update (APDU) and the State Child Support Enforcement (CSE) Special Project Report (SPR #9). Funding will be provided by the Department of Child Support Services (DCSS) through r~~R~~eappropriation, resulting in no new General Fund impact to the State over the life of the project.

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This net budget increase results from the following adjustments~~includes~~:

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- Adjustments to the Business Partner (BP) payment schedule in accordance with the terms and conditions of the contract (Payment shifts of $4,214,260 to FY 2007/08);

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- High-priority system change requests to the CSE component of the CCSAS, which are needed to comply with federal certification requirements, adapt the CSE system to changes in its external environment, and avoid negative impacts to program performance resulting from system design or implementation ($5,158,093); and

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- Use of FY 2006/07 carryover of $8,643,864 for purposes of offsetting costs associated with BP cost increases.

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This is the companion Finance Letter to the Department of Child Support Services~~'~~ (DCSS) Premise to the May Revise Local Assistance Subvention Tables.

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### ISSUE 2: VEHICLE REGISTRATION COLLECTION PROGRAM—MAY REVISION

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The FTB requests 24 two-year limited term positions (22.9 PYs) and funding of $1,551,000 ($1 million from the Motor Vehicle License Fee Account and $543,000 from the Motor Vehicle Account) The Vehicle Registration Collection (VRC) program currently has a budget of $6.3 million and 61.9 positions. There has been unprecedented workload growth in the past five years resulting in increased call demand and correspondence and account transactions. Franchise Tax Board (FTB) will be unable to continue meeting VRC program collection requirements without a budget and staff augmentation.

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Annually, the Department of Motor Vehicles (DMV) sends nearly 26 million vehicle registration notices to Californians; approximately 1 million of these accounts with an estimated value of $188 million become delinquent and are forwarded to the FTB for collection~~—~~. The collected proceeds are deposited in the Motor Vehicle Account (for the registration portion) and the Motor Vehicle License Fee Account (for the Vehicle License Fee Portion). Consequently, the VRC program costs are shared by these two funds.

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~~ITEM 0860 STATE BOARD OF EQUALIZATION~~

~~ISSUE 1: SAVINGS FROM ELECTRONIC FILING~~

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# ITEMS TO BE HEARD

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## ITEM 0860 STATE BOARD OF EQUALIZATION
## ITEM 1730 FRANCHISE TAX BOARD
## ITEM 7100 EMPLOYMENT DEVELOPMENT DEPARTMENT

## ISSUE 1: TAX AGENCY INFORMATION AND DATA EXCHANGE

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At its March 13th hearing, the subcommittee directed the state's three primary tax agencies—the State Board of Equalization (BOE), the Franchise Tax Board (FTB), and the Employment Development Department (EDD)—to work with the Department of Finance (DOF) and the Legislative Analyst's Office (LAO) and report back with specific proposals, which could include a proposal for a third-party review and analysis of the business needs of the tax agencies and potential technology approaches to improve data sharing and information exchange. This direction was the result of Supplemental Report Language adopted as part of the 2005-06 Budget and a resulting LAO report that was released in January.

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Based upon their findings in the report and in order to ensure that timely progress is made in the area of information and data sharing, LAO recommended that BOE, FTB, and EDD identify the following:

1. Those cost-efficient, data-sharing actions they are planning to undertake or could undertake immediately (that is, which require no additional funding or statutory changes).

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2. Relevant information and recommendations regarding other initiatives that may

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require legislative actions (such as statutory changes or added funding).

3. An alternative technology approach, such as using software overlays, to link existing independent tax information systems— including its costs, benefits, and time requirements.

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LAO also recommended that the three agencies should collectively identify their preferred means for coordinating data-related decisions and activities amongst themselves, such as use of the already established Strategic Tax Partnership or other alternative approaches.

## RESPONSE OF THE TAX AGENCIES

On April 27th, the three tax agencies provided a response to the LAO and legislative staff. The primary elements of that response are summarized below.

### Future Data Sharing Efforts

Attachment #1 (included at the end of ~~in~~ the~~is~~ agenda)~~ at the end of this issue)~~ lists specific data sharing initiatives that the three tax agencies will pursue in the next 2 – 3 years with notations as to which initiatives require funding or legislation. These initiatives would build upon data sharing agreements already in place. Between the three tax ~~agencies~~agencies, there are over 400 data sharing efforts with other State departments, the IRS, local and state agencies, and the private sector.

### Governance Structure

The three tax agencies indicate that they intend to use the existing FedState Partnership. According to the agencies, this partnership, established in 1993, has proven its value as a forum for collaboration and the sharing of information and "best practices" in tax administration.

With respect to tax information sharing, the FedState Partnership facilitated a Federal Information Redisclosure Agreement with the IRS to allow direct exchange between the tax agencies of confidential federal tax information. The approved agreement from the IRS effectively treats the Partnership as a single tax agency for purposes of receiving and sharing federal tax information through FTB.

The FedState Partnership is currently engaged in the following three data sharing initiatives:

- ***Business Licensing Inspection Program*** – BOE is identifying taxpayers who are required to collect sales and use tax in San Francisco and Los Angeles and is sharing that information with EDD and FTB. FTB and EDD will use this information to identify additional non-filers and to create audit and collection leads.

- ***Sharing Customs and CA Department of Agriculture (CFDA) Information*** – BOE will share this information with FTB. FTB will use this information to identify additional non-filers and to create audit and collection leads.

- ***Multi Agency Contract for Lexis / Nexis*** – A single contract is being explored for Lexis / Nexis services that will meet each agency's data needs and reduce State costs.

The FedState Partnership will work closely in tandem with Tax Gap efforts of the three tax agencies to identify future data sharing initiatives. Recent tax gap efforts resulted in the following information being added to FTB's Integrated Non-filer Compliance (INC) system, which is accessible to all three tax agencies:

- Motor fuel data from BOE.
- Business license data from several California cities.

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- Liquor license data from the Alcohol Beverage Control (ABC).
- Licensed childcare provider data from the Department of Social Services.

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## Technology Solutions

The three tax agencies believe that the partnership is an effective governance structure that can continue to effectively facilitate future data sharing and use by evaluating and determining appropriate implementation plans for those efforts. However, they recognize that specific expertise is needed to identify technology solutions and develop implementation strategies that will support expanded information sharing and use.

***Recommendation for Technology Consultant.*** The three tax agencies agree that the idea of an alternative technology approach such as a "software overlay" or other technology enhancements characterized in the LAO report has merit. While the FedState partnership has had prior discussions in this area, a comprehensive technology solution has not yet been explored by the three sister agencies corporately.

The three tax agencies recommend engaging the services of a consultant to explore existing technology solutions to increase data sharing efforts and promote compliance. This would provide for the impartial expertise desirable to ensure an unbiased analysis is completed timely. While the specifics and deliverables of the consultant services would be determined under the leadership of the FedState Partnership, the following three general areas would be addressed by the consultant:

- Work with the three tax agencies to identify common business objectives and information sharing opportunities, including:
  - An assessment of the business processes, missions, objectives, governance, technologies, and readiness of the three tax agencies to support additional information sharing and use through technology.
  - Development of an inventory of available information and how it may be used to achieve our individual and collective missions and objectives.
- Identify current and emerging technologies that will enable information sharing and use to achieve the programmatic missions and objectives of the agencies.
- Work with the three tax agencies to develop a collaborative information technology strategy that leverages individual initiatives and technologies, to maximize results for the short term, near term, and long term. Where possible, the consultant would also develop estimates of the costs and benefits associated with any recommendations made.

The deliverable of the consultant services would be recommended strategies and steps to further data sharing and use by the three tax agencies.

***LAO Response.*** The LAO generally concurs with the recommendations of the three agencies. However, LAO points out that the agencies should identify the necessary parties to the MOUs that would be needed to implement the listed data sharing efforts. LAO also points out that any funding provided for the technology consultant should primarily be for Technology Identification and Development of a Collaborative Strategy, since much of the other work already was

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covered in the LAO report.

## COMMENTS

At its May 8th hearing, the subcommittee reallocated a total of $865,000 that was budgeted for FTB Tax Gap Efforts, with $615,000 redirected to higher payoff activities and $250,000 reserved for potential funding of the technology consultant contract for the Tax Information and Data Exchange effort.

***Suggested Language.*** Staff suggests approval of the $250,000 redirection, plus the following Budget Bill language for Item 1730-001-0001 (FTB):

> Of the amount appropriated in this item, $250,000 is for the Franchise Tax Board, working with the Board of Equalization, the Employment Development Department through the Fed/State Partnership, to contract for a technology consultant to explore existing technology solutions to increase data sharing efforts and promote compliance. The consultant's work shall emphasize Technology Identification and Development of a Collaborative Strategy, as described in the memorandum of April 27th, 2007 from the Fed/State Partnership to the Legislative Analyst's Office. The FTB, through the Fed/State Partnership shall report to the Legislature by March 15, 2008 on the status of the consultant contract and work product, and shall provide an update of the list of Future Data Sharing Efforts that was provided with the April 27th memorandum.

~~**Staff Recommendation:**~~

~~**Approve redirection of the reserved $250,000 FOR A technology consultant and adopt the Budget Bill Language suggested above to specify the use of the funds and to provide a report to the Legislature.**~~

~~**[ATTACH LIST OF DATA SHARING PROJECTS—GET FROM DAN R.]**~~

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## ITEM 0860 STATE BOARD OF EQUALIZATION

### ISSUE 1: LOCAL ASSESSORS—OPPORTUNITIES FOR INCREASED PROPERTY TAX AND USE TAX REVENUES

Prior to 2005-06, local property tax assessors received about $60 million annually in Property Tax Administration Program grants from the state General Fund. Funding for that program was eliminated as part of budget-balancing actions in 2005-06.

***State Interest in Property Tax Revenue.*** The state has a vital fiscal interest in property tax revenues through its financing of K-14 Education (school districts and community college districts). On the margin, K-14 Education receives approximately 40 percent of property tax revenues statewide. These revenues offset, on a dollar-for-dollar basis, the state's General Fund Proposition 98 funding obligation. Consequently, the state receives the benefit of about 40 cents out of each additional dollar of property tax collections on average (except in Basic Aid districts).

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***Business Use Tax Collection Problems.*** The state also shares with local government a vital interest in Use Tax collection. The Use Tax is the equivalent of the Sales Tax. Use Tax is owed by the purchaser when the seller is not required to collect sales tax. For example, a California business owes Use Tax if it purchases office equipment from an out-of-state seller who ships via a common carrier. Revenue from the Use Tax is split between the state and local governments in the same manner as Sales Tax. The State Board of Equalization (BOE) is responsible for collecting state and local sales and use taxes. The board regularly audits registered sellers (businesses that engage in retail sales and have seller's permits issued by the board). These audits also discover unpaid use tax liability on the part of these businesses. However, many businesses are not retailers and therefore are not required to have seller's permits. Many professional businesses, such as law firms and accounting firms, fall into this category. The BOE normally does not audit these businesses, and so it has limited ability to enforce payment of Use Tax by them. The board estimated in 2005 that the Tax Gap from uncollected business Use Tax is over $600 million annually (of which $400 million is a state loss).

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**Potential Efforts by Assessors**

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With some additional resources, assessors potentially could increase revenues from existing taxes in a number of ways, including the following:

- ***Aircraft Property Taxes.*** Existing law ~~taxes~~ generally taxes aircraft as personal property~~–~~. Assessors estimate that they could generate more than $25 million annually in additional property tax revenue ($10 million state benefit) from assessing noncommercial aircraft that currently escape property tax assessment. This would be accomplished through statutory change to require non-commercial airports to provide assessors with annual tenant lists. Assessors would then follow up with property tax assessments (taking into account the usage of the aircraft in California).

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- ***Use Tax.*** Businesses are required to file annual personal property statements with their county assessor. In addition, assessors have field staff who visit businesses (including businesses that are not registered with BOE) to check for both personal property acquisitions and real property improvements that are subject to property tax assessment. The annual business personal property statement could be modified (through statute) to include a declaration as to whether sales tax or use tax had been paid on new property. Assessor field staff, with some training by BOE, could make businesses aware of their liability for use tax and how to pay use tax to the BOE. They could refer leads to BOE and they could perform limited initial contact or preliminary investigative work to help BOE efficiently focus its use tax enforcement efforts. BOE would retain the actual enforcement and collection authority for sales and use taxes.

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## COMMENTS

The assessors and the BOE have held discussions and explored some aspects of these proposals. Given the potential for additional state savings and revenues from enhanced collection of existing taxes, staff suggests adoption of a placeholder action to put this issue in Conference so that a more specific proposal can be developed.

The actual effect of these proposals would be both Proposition 98 savings and increased Use Tax revenue. There also would be a need to provide additional funding to the assessors to carry out these tasks. For simplicity, staff suggests scoring a net General Fund savings of $10 million as a placeholder action.

~~**Staff Recommendation:**~~

~~**Adopt placeholder net General Fund savings of $10 million.**~~

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~~**ITEM 0860 STATE BOARD OF EQUALIZATION**~~

## ~~ISSUE 1: SAVINGS FROM ELECTRONIC FILING~~

~~The Subcommittee first heard this issue on March 13th and held it open pending additional information and analysis by LAO. At that time LAO withheld recommendation on the board's electronic filing infrastructure enhancements and recommended that the board report at budget hearings regarding the status of efforts to develop a cost-savings model, together with estimates of medium- and long-term savings and costs associated with increased conversion of existing registrations, tax filings, and manual processing to electronic systems.~~

~~The Board of Equalization (BOE) has since provided legislative staff with the following table of potential savings estimates:~~

| | | | | |
|---|---|---|---|---|
| ~~2008-09~~ | ~~10%~~ | ~~$794,897~~ | ~~$132,565~~ | ~~$927,462~~ |
| ~~2009-10~~ | ~~20%~~ | ~~1,589,794~~ | ~~265,130~~ | ~~1,854,924~~ |

~~The BOE is still unwilling to identify potential savings in 2007-08 because the program is still in its early stages and data is unreliable; however, the BOE indicates that beginning in 2008 e-filers will have the option of remitting payment by check (currently they must use e-payment), and this is anticipated to have a marked impact on participation levels. For example, the e-filing participation rate is currently 2.5 percent, but the BOE expects it to quadruple by 2008-09 as the result of the new remittance policy combined with the following *filing strategies the department intends to pursue to market e-filing:*~~

- ~~***Combine Seller's Permit and E-Client Registration Process***. Individuals selling tangible tangible personal property in California must register for a seller's permit with the BOE. At the BOE. At the time of registration for a seller's permit, the BOE plans to also register taxpayers for taxpayers for e-filing.~~
- ~~***Discontinue Sending Paper Tax Returns.*** Paper tax returns are sent to sales and use taxpayers that report either on a monthly, quarterly, fiscal yearly or calendar yearly basis whether or not basis whether or not they e-file (unless the taxpayer has elected to no longer receive paper longer receive paper returns). The BOE is developing a pilot project to discontinue sending paper sending paper returns to certain taxpayer groups.~~
- ~~***Outreach Efforts***. The BOE has developed an Outreach Plan that will focus on new and innovative approaches to marketing e-services, such as on-line tutorials/videos, focus groups and speaking cus groups and speaking engagements.~~

~~**LAO Recommendation**~~

~~The LAO now recommends approval of the BOE budget request to continue its e-filing efforts. However, LAO also recommends adoption of the following Budget Bill Language:~~

> ~~It is the intent of the Legislature that the funds appropriated for the Board of Equalization Electronic Filing Infrastructure Project be used to improve the State's efficiencies in tax administration. The Board of Equalization shall report to the Department of Finance and the~~

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~~appropriate fiscal committees of the Legislature on March 1, 2008 and March 1, 2009 on the status of Electronic Filing at the Board of Equalization, including the following:~~

- ~~The current level of Electronic Filing participation;~~

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- ~~Any revised estimates of future Electronic Filing participation, including progress in reaching 10 percent participation in 2008-09 and 20 percent in 2009-10.~~

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- ~~The department's estimate of current and future annual savings associated with increased use of increased use of Electronic Services at the Board of Equalization.~~

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- ~~Any identified implementation problems or barriers to additional participation.~~

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**~~COMMENTS~~**

~~The LAO indicates that the BOE and the Department of Finance do not object to their recommended language.~~

**~~Staff Recommendation:~~**

**~~Approve the budget request and adopt the LAO recommended reporting language.~~**

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## ~~ISSUE 2: MAINTENANCE AND REPAIR COSTS—FINANCE LETTER~~

~~In a letter dated March 29th, the Director of Finance requested an augmentation totaling $524,000 ($300,000 General Fund) for building maintenance and repair costs identified by the Department of General Services. The amount consists of $163,000 for fire and life safety systems, including elevators, and $361,000 for cyclical repairs, such as roof replacement and periodic maintenance of the window wall at the Sacramento headquarters.~~

### ~~COMMENTS~~

~~No issues have been raised regarding this request.~~

**~~Staff Recommendation:~~**

**~~Approve the Finance Letter request.~~**

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## ITEM 1730 FRANCHISE TAX BOARD

## ~~ISSUE 1: PROPOSALS TO REDUCE THE TAX GAP~~

## ISSUE 1: ADDITIONAL SAVINGS FROM E-SERVICES

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At its March 13th hearing, the subcommittee heard an LAO recommendation ~~to~~ for a $500,000 (General Fund) reduction to the FTB budget to account for savings associated with increased use of business-entity electronic return processing, electronic remittance processing, and associated reductions in the amount of paper printing and mailings~~–~~. The LAO points out while the 2007-08 budget includes savings of $298,000 due to increased electronic filing for the Personal Income Tax (PIT), the budget does not recognize savings from increased electronic remittance processing or reductions in mailed and printed tax forms and booklets due to more use of online forms and other information. The board is also expanding the Business Entities E-File (BEEF) system, but did not account for any savings associated with increased electronic filing of BEEF returns.

## COMMENTS

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At the March 13th hearing, FTB indicated that it planned on using these savings to offset the potential impact of the unallocated reduction that is proposed in the Governor's b~~B~~udget~~–~~. However, FTB now indicates that it has other plans for absorbing the unallocated reductions, and that these actions will not adversely affect revenues.

**~~Staff Recommendation:~~**

**~~Adopt LAO recommended reduction of $500,000.~~**

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## ITEM 8885 COMMISSION ON STATE MANDATES

### ISSUE 1: REAPPROPRIATION FOR MANDATE PAYMENTS—MAY REVISION

A May Revision Finance Letter requests a reappropriation of $41 million (General Fund) from the local government mandates payment appropriation in the 2006-07 Budget Act ($232.5 million). This reappropriation is requested to pay additional claims for costs incurred in the 2004-05, 2005-06, and 2007-08 fiscal years and to pay for the statewide cost estimates for two newly determined mandates. Most of these claims are for costs incurred in 2004-05. This reappropriation would be available for expenditure for two years. Payment of these claims generally is necessary to avoid the suspension requirement of Proposition 1A.

### COMMENTS

1. ***Reappropriation Should Be Limited to One Year.*** There is no need to provide two-year funding for these past claims. The amount of overall outstanding mandate claims should be re-evaluated each year. Having multiple overlapping appropriations creates unnecessary complications.
2. ***Peace Officer Procedural Bill of Rights (POBOR) Claims should be Excluded~~.~~.*** As proposed, the language of the reappropriation would authorize payment of past POBOR claims because the reappropriated item included $16 million each year for POBOR claims in 2005-06 and 2006-07. However, POBOR is not subject to Proposition 1A's suspension requirement, and remaining unpaid POBOR claims are handled as part of the annual payment of deferred mandate claims.
3. **Existing Provisional Language Is Superfluous.** Item 8885-295-0001 of the 2007-08 Budget Bill includes a provision allowing the Director of Finance to augment the item to pay any unpaid claims for 2006-07 mandate costs. This open-ended spending authority would not appear to be necessary in light of the proposed reappropriation. The specific language that should be deleted is Provision 1:

> ~~If the amount in Schedule (1) of Item 8885-295-0001 of the 2006 Budget Act (Ch. 47, Stats.2006) is insufficient to pay claims for costs incurred to carry out the cited state mandates in the 2006-07 fiscal year, the Controller shall notify the Director of Finance of the amount of the deficiency and, with the approval of the director, shall augment the amount in Schedule (1). The director shall notify the Chairperson of the Joint Legislative Budget Committee and the chairpersons of the fiscal committees in both houses of the Legislature prior to authorizing any augmentation pursuant to this provision.~~

~~**Staff Recommendation:**~~

~~**Adopt Reappropriation in the Finance Letter with the following modifications:**~~

~~Limit to one year (not two).~~

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- ~~Exclude POBOR from the reappropriation.~~
- ~~Delete Provision 1 in the existing Budget Bill language.~~

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## ISSUE 2: TECHNICAL CLEANUP TRAILER BILL LANGUAGE

Commission staff, along with the LAO, Department of Finance, and the State Controller's Office have been developing technical cleanup Trailer Bill Language in response to direction of the Subcommittee at its April 24th hearing. The LAO has pointed out that the current budget funding approach for mandates is not consistent with existing statutory mandate claiming and payment provisions. For example, statute calls for claims to be paid on a current basis each year, while the budget calls for 2007-08 claims to be paid in the following year, as permitted under Proposition 1A. Also, existing law calls for an annual Mandate Claims Bill, while current practice is to fund mandates through the annual Budget.

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## COMMENTS

Staff suggests that the Subcommittee adopt the language developed by the various staffs as placeholder Trailer Bill Language. This will enable the language to be circulated to local governments, education organizations, and other interested parities to enable any errors, omissions, or unintended effects to be corrected.

Mandate Reform (in contrast to technical cleanup) is being addressed in legislation through the policy process.

**~~Staff Recommendation:~~**

**~~Adopt DOF mandate technical cleanup language as placeholder Trailer Bill Language.~~**

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## ITEM 9618 ECONOMIC RECOVERY BOND EXTRA PAYMENT

The Governor's Budget proposes to appropriate $595 million from the General Fund to further accelerate the payoff of the Economic Recovery Bonds (ERBs). This amount is over and above the approximately $1.5 billion that will be paid from the dedicated quarter-cent sales tax revenue and the additional $1 billion allocation from the amount deposited in the Budget Stabilization Account (BSA) in 2007-08 pursuant to Proposition 58—a total of about $2.5 billion. These payments fully satisfy the state's ERB payment obligations in 2007-08. In fact, the extra $1 billion payment from the BSA is an optional payoff acceleration in the sense that the Governor could act to waive it.

### COMMENTS

***Extra Payment Not Prudent at this Time.*** Based on the LAO's assessment of the Governor's May Revision, the budget reserve could be minimal. Accordingly, it would not be prudent to spend an additional $595 million for additional acceleration of the ERB payments. An analogy might be making extra mortgage payments with the money that will be needed to pay utility bills.

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## CONTROL SECTIONS 4.04/4.05 UNALLOCATED REDUCTIONS

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The Subcommittee originally heard these issues at its May 1st hearing but held them open pending the May Revision update of the budget.

### Control Section 4.04: Unallocated "Price" Reduction

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In a letter dated January 19, 2007, the Department of Finance (DOF) submitted a Finance Letter requesting the addition of Control Section 4.04, which would authorize the Director of Finance to reduce General Fund items of appropriation by up to a total of $46.3 million. The reduction to any department could not exceed half of the funding provided for the 2007-08 General Fund price increase (the annual budget adjustment for the projected increase in the cost of operating expenses and equipment). The language also limits the reduction to the amount needed to eliminate any state operating deficit in 2007-08, as determined by the Director of Finance. The proposed language exempts the Legislature, Constitutional Officers, and the Judicial Branch from this reduction.

***Operating Deficit Provision Now Superfluous***~~.~~. The provision limiting the reduction to the amount needed to eliminate an operating deficit now is superfluous because the Governor's May Revision Budget still has an operating deficit even with scoring full savings from this provision~~.~~. Therefore, the following sentence should be stricken from proposed Control Section 4.04:

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> ~~Reductions shall be made only to the extent necessary to ensure that there is no operating deficit in 2007-08, as determined by the Director of Finance.~~

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### Control Section 4.05: $100 million Unallocated General Fund Reduction

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This Control Section in the Governor's budget requires a one-time $100 million unallocated reduction for state agencies' General Fund appropriations. The Director of Finance could provide Agency Secretaries with target amounts, and the secretaries would provide the director with recommended reductions. The director would determine reductions directly for departments not reporting to a secretary, and would make the final decision on all reductions.

***Limits on Reductions and Credits for Other Savings.*** General Fund savings credited to another fiscal year also could be counted towards the $100 million, as could savings in special funds that would revert to the General Fund in 2007-08. The language places a 20-percent maximum on reductions to any state operations item or to any program or project or function scheduled in that item; and a 5-percent limit on any local assistance appropriation or scheduled program, project, or function in that item.

***Exemptions.*** The language exempts the following entities from the reductions: Higher Education; the Judicial Branch, the Legislature, Legislative Counsel Bureau, Constitutional Officers, Debt Service, Health and Dental Benefits for Annuitants, Augmentations for Contingencies and Emergencies, and Equity Claims before the California Victim Compensation and Government Claims Board~~–~~. *However, these exemptions would not apply if the Director of Finance determined that the savings would not negatively impact program needs as provided for in the enacted budget or other existing law.*

***Report***~~–~~. The Control Section requires the Director of Finance to report to the Legislature on specific reductions by February 15, 2008.

## COMMENTS

1. At its previous hearing, the subcommittee expressed a preference for more specificity~~–~~. However, staff is not aware of any additional information provided by the administration (other than a plan presented by the Franchise Tax Board for its reduction).

2. The LAO has recommended against these unallocated reductions and pointed out that historically, most of the savings from these types of reductions would have occurred anyway.

3. The following language modification would require the agreement of otherwise exempted entities prior to any reduction by the Director of Finance:

   (b) The Director of Finance shall not reduce, pursuant to subdivision (a), the amounts appropriated for the following: higher education; the judicial branch; the Legislature; the Legislative Counsel Bureau; constitutional officers; debt service, including, but not limited to, tobacco settlement revenue shortfall, payment of interest on General Fund loans, and interest payments to the federal government; health and dental benefits for annuitants; equity claims before the California Victim Compensation and Government Claims Board; or augmentations for contingencies or emergencies, unless the savings identified would not negatively impact program needs as provided for in this act or current law *and provided that the affected entity, or the state official responsible for that expenditure, concurs with the reduction.*

~~**Staff Recommendation:**~~

~~**Adopt Control Sections 4.04 and 4.05 with the language modifications suggested by staff for each control section.**~~

~~Note: While the LAO is correct that these control sections do not represent good budgeting, it would be very difficult, given the difficult budget situation, to find another $143.6 million of savings to replace the amounts scored for these provisions.~~

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## CONTROL SEC. 35.60 AUTHORIZATION TO TRANSFER BUDGET STABILIZATION ACCOUNT TO THE GENERAL FUND

***Prior Action***. The Subcommittee acted to delete this control section at its May 1st hearing. However, the deterioration in the budget reflected in the May Revision necessitates restoring this authority. Based on the LAO's assessment of the Governor's May Revision, for example, a transfer of $1 billion from the Budget Stabilization Account (BSA) would be needed to fund the Governor's expenditures. Final budget actions will determine whether a BSA transfer is needed and how much it might be, but based on the LAO assessment, it now appears prudent to reinstate Control Section 35.60 as proposed in the Governor's Budget.

**Budget Stabilization Account (BSA).** Proposition 58, approved by the voters in the March 2004 primary election, requires 1 percent of estimated General Fund revenues to be transferred to the BSA in 2006-07, 2 percent in 2007-08, and 3 percent in 2008-09 and annually thereafter, until the BSA reaches the greater of $8 billion or 5 percent of General Fund revenues. The constitution allows the Governor to suspend transfers to the BSA, but the Governor must act to do so by June 1 of the *prior* fiscal year. Also, while the Economic Recovery Bonds (ERBs) are outstanding, half of the annual transfers to the BSA (up to a cumulative total of $5 billion) are appropriated to accelerate their repayment. The constitution provides that once funds are in the BSA they may, by law, be transferred into the General Fund. Control Section 35.6 would provide this legal authority for 2007-08.

The Governor's budget estimates that about $2 billion will be transferred to the BSA in 2007-08, of which half would go towards repayment of the ERBs and the remainder ($1 billion) would remain in the BSA. The total balance in the BSA would be about $1.5 billion (after the debt service payment), including a carryover balance from the current year of $472 million. However, based on the LAO's assessment of the May Revision, some of this money would be needed to keep the General Fund in balance.

~~Staff Recommendation:~~

**~~Rescind prior action to delete Control Section 35.60.~~**

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~~The Governor's budget proposes $19.6 million (General Fund) and 230 positions for various efforts to close the state's estimated $6.5 billion tax gap. Of the proposed resources, $13.6 million and 180.5 positions continue six existing pilot programs proposed for permanent establishment. The existing programs concentrate on detecting non-filers and filers of fraudulent returns and on audit and collections activities. The FTB estimates that these programs will generate $64.7 million in revenues in 2007-08, and $68.5 million in revenues in 2008-09. The remaining $6 million and 49.5 positions are for new initiatives to educate independent contractors about filing requirements, expand the corporate non-filer program, address out-of-state tax avoidance, and increase investigations of persons who fail to file a return, or who file fraudulent returns. The budget estimates that these new initiatives will generate additional revenues of $12.8 million in 2007-08, and $29.8 million in 2008-09.~~

**~~Background on the Tax Gap~~**

~~The Franchise Tax Board (FTB) estimates that the tax gap, the difference between what taxpayers actually pay and what they owe, is around $6.5 billion annually for the Personal Income Tax (PIT) and the Corporation Tax (CT). In a typical tax year approximately 89 percent of all taxes owed are ultimately paid, with the remaining 11 percent constituting the tax gap. The tax gap results in lost revenue and therefore less ability to support public programs under the existing tax structure. Furthermore, it is harmful to those who do pay their taxes fully because their taxes end up being higher than they otherwise would have to be to generate current revenues, and the tax gap undermines public perceptions of the fairness of the tax system. The tax gap is manifested in three ways: Improper filing by underreporting income and overstating deductions and credits, non-filing of tax returns, and underpayment of amounts owed. Improper filing is by far the most common form (80 percent of total) with non-filing and underpayments making up the remaining causes (about 10 percent each), according to the FTB.~~

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~~**Continuation of Recent Pilot Programs**~~

~~In the 2005-06 Budget Act, the Legislature approved six two-year pilot programs (at a cost of $13.6 million and with 175.5 positions), that expanded FTB's ongoing efforts in the following areas: (1) detecting tax preparers filing fraudulent returns with fictitious refundable credits, (2) developing additional information to detect PIT non-filers, (3) conducting underground economy criminal investigations, (4) pursuing audit cases down to a 4-to-1 benefit-cost ratio (BCR)—versus the former 5-to-1 ratio, (5) targeting collection enforcement activities down to a 3-to-1 BCR, and (6) engaging in discovery audits to detect new forms of tax evasion or areas of confusion for law-abiding taxpayers. The pilot programs were successful at bringing in $56.3 million of additional General Fund revenue in 2005-06, an increase of $4.5 million over the original estimates. The 2007-08 budget proposes to make these pilot programs permanent. The FTB projects that these programs will produce $64.7 million in revenue at a cost of $13.6 million and 180.5 positions in 2007-08.~~

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~~**New Initiatives for 2007-08**~~

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~~The Administration proposes four new tax gap initiatives for the budget year. These proposals would add 49.5 positions, at a General Fund cost of $6 million. The four new initiatives are projected to generate $12.8 million in additional revenue in 2007-08, tripling to almost $40 million by 2009-10.~~

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~~The new initiatives consist of the following four programs:~~

- ~~***Focus on Independent Contractors.*** This proposal targets independent contractors who do not fully report income or who deduct more than allowable expenses on their tax returns. (The FTB estimates that approximately $3.5 billion of the state's tax gap is attributable to sole proprietors, many of whom are independent contractors). The proposal would fund six new positions at a cost of $581,000 in 2007-08. The funds would be used both for education and outreach, and increased audits of noncompliant taxpayers. The FTB estimates the program would raise $1.5 million in 2007-08, increasing to $5.9 million in 2008-09.~~

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~~• ***Expand the Corporate Non-filer Program.*** This proposal focuses on noncompliance of certain business-entity non-filers by augmenting FTB's Integrated Non-Filer Compliance System. The funds would allow FTB to access more data sources to identify business non-filers. Additional data sources include federal 1099 and 1098 tax forms and various California business-related tax forms. (The FTB estimates that approximately 5,900 additional non-filers could be identified if these data sources were available). The proposal would fund 7.5 new positions at a cost of $1.3 million in 2007-08. The FTB estimates that this program would raise $900,000 in 2007-08, for a net loss of about $400,000, but the investment would produce a rapidly growing return, reaching $8.4 million in 2009-10.~~

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~~• ***Out-of-State Tax Avoidance.*** This proposal targets out-of-state taxpayers who intentionally avoid California income taxes. In particular, it would focus on taxpayers who use a series of transactions often referred to as tax schemes (including sham corporations), promoters of tax schemes, California residents filing as nonresidents, and noncompliance in the entertainment industry. Additionally, the proposal would enable FTB to identify and pursue those individuals who promote tax schemes and assess penalties for tax avoidance where appropriate. Finally, this measure would provide expanded education and outreach programs for tax practitioners and others who deal with out-of-state taxpayers. The proposal would fund 23 new positions, at a cost of $2.3 million in 2007-08. The FTB estimates it would raise $10.4 million in 2007-08, increasing to $16.8 million in 2008-09.~~

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~~• ***Expand Investigation Workloads.*** This proposal expands identification, investigation, and prosecution of taxpayers who fail to file a return or who submit a false return to the state. Based on historical modeling and future projections, FTB investigations staff have identified 148 additional cases that could be opened immediately, involving more than $98 million in unreported income. The proposal would fund 13 new positions at a cost of $1.8 million in 2007-08. The FTB estimates that increased enforcement not only will result in collections from the prosecuted cases, but that it also will result in increased voluntary compliance. The FTB estimates that this increased voluntary compliance will generate $13 million in annual revenue beginning in 2009-10.~~

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~~**Legislative Analyst's Office (LAO) Recommendation**~~

~~In its analysis of the Governor's budget, the LAO noted concerns with this proposal and recommended redirecting some of the proposed funding to tax gap enforcement activities with a higher benefit-to-cost ratio. Based on additional information from the FTB, the LAO now has revised their recommendation as follows:~~

- ~~Reallocate $865,000 from the proposed Underground Economy Criminal Investigations program, with $615,000 directed to augment the Corporate Non-filer program (which has a significantly higher benefit-cost ratio), and reserve $250,000 to pay a portion of contractor expenses associated with assessment of a "software overlay" approach for the three tax agencies (per LAO's Report on Tax Agency Information and Data Exchange).~~

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- ~~Given the low benefit-cost ratio (BCR) of 2.2-to-1 reported for the Underground Economy Criminal Investigations program up to this point, LAO recommends continuing the program on a two-year limited-term basis to provide for a reevaluation.~~

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~~The LAO estimates the above recommended changes to the proposed tax gap initiatives would generate approximately $2 million of additional General Fund revenue in the budget year at the same overall level of expenditures contained in the Governor's budget.~~

~~COMMENTS~~

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- ~~About half of the current funding level would still remain (about $900,000) for underground economy criminal investigations after the LAO's recommended redirection of funding to higher-payoff activities and the tax agency information sharing project.~~

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~~Staff Recommendation:~~

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~~**Adopt the LAO recommendation and recognize $2 million of additional General Fund revenue in 2007-08.**~~

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~~Issue 2: Legal Support for combating abusive tax shelters~~

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~~The Governor's budget requests $1.3 million (General Fund) and 10 new positions to address Abusive Tax Shelter workloads.~~

~~The FTB believes that there is sufficient workload to merit the staffing requested and that this investment will result in additional revenues of approximately $1.4 billion [above and beyond the $1.4 billion collected during the former Voluntary Compliance Initiative (VCI), but inclusive of the additional $348 million in subsequent tax shelter assessments]. Given the extreme complexity of abusive tax shelter cases, the combativeness of representatives and investors, and the fact that the VCI accelerated the easiest cases, the FTB has estimated that it may take up to eight years to collect this revenue.~~

~~According to the FTB, while the Abusive Tax Shelter program has been a success, there is no indication that abusive tax shelters will go away at any time in the near future. The FTB expects that as California's economy continues to grow and global competition increases, individuals, and companies will continue to seek ways to minimize their tax burden, and the products available will constantly seek to push, and ultimately step over, the line between tax planning and tax abuse. For example, even after nearly a decade of discussion and calls for better enforcement at the federal level, the U.S. Senate Permanent Subcommittee on Investigations reported, in August 2006, a federal tax loss of over $100 billion annually from offshore tax havens and tax shelter abuses. The FTB believes that high profile enforcement and public disclosure will continue to discourage abusive tax shelter investments and discourage investors from considering abusive schemes; however, constant vigilance will be the only mechanism to successfully control the proliferation of new iterations of tax shelter schemes.~~

~~The FTB does not project that additional auditor, attorney, or collector position requests will be made in the future to produce the $1.4 billion in revenue currently estimated to be realized from the abusive tax shelter program. Should the FTB's efforts identify a new inventory of tax shelter cases, which will generate additional revenues and require resources, the department would redirect resources from lower cost-benefit workloads and/or present the Legislature with the opportunity to fund those workloads.~~

~~***LAO Now Recommends Approval.*** The LAO previously articulated concern over the future~~

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~~staffing needs of this program, noting that while attorneys may be necessary to process the up-front workload, collectors and auditors would likely be necessary as well. However, the FTB has clarified that while the targets of the requested attorneys are generally well-funded; they are relatively few in number. Thus, the FTB expects that audits and collections activities could be handled within existing resources. Given this clarification, the LAO now recommends approval.~~

~~Staff Recommendation:~~

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~~**Approve as budgeted.**~~

~~Issue 3: Improvement of telephone customer service~~

~~The Governor's budget requests $1.3 million (General Fund) and 27 positions to restore staffing levels in the Franchise Tax Board's Contact Centers and related supporting workloads. These call center positions were eliminated in recent years to meet budget reduction targets and the department now asks that they be restored in order to meet a response target of responding to 95 percent of all calls with 80 percent answered within 2 minutes.~~

**~~Current Level of Telephone Customer Service~~**

~~The FTB provided the tables below, which reflect the Level of Access (LOA), Level of Service (LOS), and Average Wait Times associated with current and proposed staffing levels. The LOA represents the percentage of calls the answered by an FTB Customer Service Representative (CSR) compared to total calls received, while the LOS represents the percentage calls answered within the FTB's two-minute target time period. The Average Wait Time represents the time a caller spends on hold waiting to talk to a live agent after their call has been received by the Interactive Voice Response (IVR) system and they have made a selection to request to speak to a CSR. Staff notes, the amount of time a caller spends "surfing" the IVR is not included in these statistics, nor does the FTB record this data.~~

~~Existing staff levels provided an average LOA of approximately 67 percent in 2006, meaning that 33 percent of callers (nearly 700,000) seeking to speak to a CSR failed to do so. Unsurprisingly, the highest LOA corresponds to the lowest level of calls (in December) and the lowest LOA corresponds to the highest level of calls (in May, when taxpayers call about refund status). However, the LOA remains relatively low (hovering between 50 and 60 percent) throughout the months of June, July, and August, even as calls decline by almost 50 percent.~~

~~Table 1 below breaks down the LOA into Peak and Non-Peak averages, and additionally shows the LOS and Average Wait Time associated with these periods. The FTB defines the Peak period as January through June, thus, the relatively low LOA of 72.6 percent for the Non-Peak period is due to the fact that the averages for July and August (approximately 52 percent and 56 percent, respectively) skew the average for the remainder of the months (which tend to hover in the vicinity of 90 percent). Table 1 indicates that during the Peak period only 15 percent of callers requiring a human response made contact with a CSR within 2 minutes, and in fact, the~~

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~~*Average Wait Time was over 6 minutes*. During the Non-Peak period, customer service improved to 40 percent of calls answered by a CSR within 2 minutes and an average wait of approximately *4 minutes*.~~

| ~~Table 1 – Level of Access (LOA), Level of Service (LOS), and Wait Times Over Peak and Non-Peak Periods for 2006.~~ | | | | | | | |
|---|---|---|---|---|---|---|---|
| ~~Level of Access~~ | | | ~~Level of Service~~ | | | ~~Average Wait Time~~ | |
| ~~Peak~~ | ~~Non-Peak~~ | ~~Total Average~~ | ~~Peak[1]~~ | ~~Non-Peak[1]~~ | ~~Total Average[1]~~ | ~~Peak[2]~~ | ~~Non-Peak[2]~~ |
| ~~64.5%~~ | ~~72.6%~~ | ~~67.1%~~ | ~~15.2%~~ | ~~40.6%~~ | ~~24.1%~~ | ~~6:17~~ | ~~4:08~~ |

~~[1] This percentage is a weighted average. [2] Although this is the average wait time, some callers waited 30-40 minutes to speak with an agent.~~

### ~~How Much Improvement Would the Additional Staff Achieve?~~

~~Based on call volumes similar to 2006, the FTB expects the requested $1.3 million augmentation to enable it to answer approximately 14 percent more calls (or 294,000) over the course of the year. This equates to a cost of $4.42 per additional call answered.~~

~~Table 2 below breaks the projected 2007-08 customer service performance into Peak and Non-Peak and displays the LOS and Average Wait Time for these periods. As compared to Table 1, the proposal would improve Peak LOS by approximately 25 percent and decrease Average Wait Time during peak months by approximately 1 minute and 45 seconds. During the Non-Peak period, the proposal would increase LOS by approximately 25 percent, but Average Wait Time would remain relatively constant at 4 minutes per call. This last conclusion appears counter-intuitive, but would seem to suggest that despite fewer calls during the Non-Peak period, the length of the average call (perhaps due to the complexity of questions) increases significantly.~~

~~Table 2 – Projected Customer Service Levels in 2007-08~~

| ~~PEAK~~ | ~~Offered~~ | ~~Answered~~ | ~~LOA~~ | ~~LOS~~ | ~~Avg. Wait Time~~ |
|---|---|---|---|---|---|
| ~~Jan-Jun~~ | ~~1,438,919~~ | ~~1,139,476~~ | ~~79.19%~~ | ~~40%~~ | ~~4:30~~ |
| ~~NON-PEAK~~ | ~~Offered~~ | ~~Answered~~ | ~~LOA~~ | ~~LOS~~ | ~~Avg. Wait Time~~ |
| ~~Jul-Dec~~ | ~~699,088~~ | ~~589,886~~ | ~~84.38%~~ | ~~65%~~ | ~~4:00~~ |

~~Overall, this proposal would provide an incremental increase in calls answered (at a cost of~~

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~~approximately $4.42 per call) and a reduction in wait times during the Peak period of the year. The optimal or desirable level of service to provide to FTB customers is a policy decision that must be weighed against other pressures on the General Fund; however, based on the FTB's own criteria, this proposal would result in progress toward achieving the department's customer service goals. If the Subcommittee decides to approve this proposal, it may wish to require the FTB to report on actual customer service outcomes in order to better inform future deliberations on customer service should those discussions arise.~~

~~**LAO Now Recommends Approval**. The LAO originally recommended reducing this proposal by about half due to concerns that the need for additional staffing was mostly seasonal. Based on the additional information provided by the FTB, LAO now recommends approval of the request and the adoption of language for a report on actual service outcomes by October 1, 2008.~~

~~COMMENTS~~

~~•***Internet is Now Primary Source of Information.*** The Internet has become the primary communications medium between the FTB and taxpayers. Accordingly, improving telephone service, while desirable, is not as crucial as it once might have been.~~

~~•***No Bright Line.*** The optimal or desirable level of telephone service to provide to FTB taxpayers is a policy decision that must be weighed against other pressures on the General Fund. However, based on the FTB's own criteria, this proposal would result in some progress toward achieving the department's customer service goals, but it still would fall short of achieving them.~~

~~Staff Recommendation:~~

~~**Reduce the request by half for a savings of $650,000 (General Fund) and 13.5 positions. Adopt Supplemental Report Language for report as recommended by LAO.**~~

~~**Notes:**~~

~~Senate deleted the entire amount, so the staff recommendation would still improve customer service relative to the Senate Version.~~

~~At the May Revision hearings, the Subcommittee may wish to use the $650,000 savings here to partly offset the $1.4 million unallocated reduction to FTB. This also would enable the Subcommittee to score $500,000 in e-filing savings that the FTB wants to retain for offsetting the unallocated cut. These actions will depend on the overall situation at May Revision.~~

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~~Issue 4: Public Disclosure of Delinquent Taxpayers~~

~~The budget requests one limited-term position and $144,000 (General Fund) to implement AB 1418 (Horton) of 2006. This legislation requires the FTB to compile a list of 250 taxpayers with the largest delinquencies over $100,000 and to make the list public on a quarterly basis (the same requirement also applies to BOE). The FTB estimates that this action will result in collection of $30 million of additional General Fund revenue in 2007-08 and $5 million annually thereafter.~~

~~COMMENTS~~

~~The Subcommittee held this issue open at its March 13th hearing pending FTB response to Mr. DeVore's request for additional information. The FTB has provided that information.~~

~~Staff Recommendation:~~

~~**Approve as budgeted.**~~

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~~Issue 5: Child support automation – Fianance letter request~~

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~~In a letter dated March 29th, the Director of Finance requested the following adjustments to the FTB budget related to the FTB's role as the information systems developer for the California Child Support Automation System Project:~~

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**California Child Support Automation System (CCSAS) Project Funding Shift (Issue 029)—**It is requested that Franchise Tax Board (FTB) shift $30.0 million of a scheduled $80.0 million business partner payment from 2008-09 to 2007-08 to fund changes in the CCSAS project schedule and the business partner's scope of work. Project staff notes the changes in schedule and scope are necessary to complete the federal certification process and relieve the state from further federal penalties. The Department of Child Support Services proposes to fund the $30.0 million reimbursement to FTB from reappropriated federal and General Fund monies. FTB will fund a required additional $3,947,000, by increasing Item 1730-001-0001 by $1,342,000 and Reimbursements by $32,605,000.

**Franchise Tax Board Provisional Language for Unanticipated Funding Needs for the CCSAS Project (Issue 030)—**It is requested that provisional language be added to ~~Item 1730-001-0001 that presently is contained in Provision 8 of Item 1730-001-0001 of~~ the Budget Act of 2006. The recommended Budget Bill language is:

> Notwithstanding any other provision of law, upon request of the Franchise Tax Board, the Department of Finance may transfer any amounts not fully expended in Schedule (4)—Child Support Automation, to the Department of Child Support Services to provide for unanticipated costs associated with the California Child Support Automation System project. This provision may become effective no sooner than 30 days after providing notification in writing to the chairpersons of the fiscal committees of each house of the Legislature and the Chairperson of the Joint Legislative Budget Committee, or not sooner than whatever lesser time the chairperson of the joint committee, or his or her designee, may in each instance determine.

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~~COMMENTS~~

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~~This request is consistent with revisions to the budget of the Department of Child Support Services, and is necessary to keep the project on schedule and avoid substantial federal penalties against the state.~~

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~~Staff Recommendation:~~

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~~**Approve the Finance Letter request.**~~