

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

**PART 1**

**Assemblymember Juan Arambula, Chair**

**Tuesday, May 27, 2008, 1:30 pm or Upon Call of the Chair**  
**State Capitol, Room 447**

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## CONSENT ITEMS

### ITEM 1730 Franchise Tax Board

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**Tax Gap – Filing Enforcement Manual Workload (May Finance Letter).** The Administration requests \$1.1 million (General Fund) and 16.2 new positions to augment the Filing Enforcement Program and contact an additional 60,000 non-filers. This proposal is expected to generate additional General Fund revenues of \$9.0 million in 2008-09 and \$28 million in 2009-10.

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**Staff Recommendation:** Approve the May Revision request.

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### ITEM 8260 CALIFORNIA ARTS COUNCIL

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#### ISSUE 1: BBR AND BCP PROPOSALS

The Subcommittee considered these issues at its March 25<sup>th</sup> hearing and the items were held open pending further review and the May Revision.

The Governor proposed expenditures of \$5.6 million (\$1.1 million General Fund) and 19.3 positions for the Arts Council, for an increase of \$245,000. This change is primarily due to two factors: (1) the Administration submitted one Budget Change Proposal – an ongoing \$335,000 increase from the Graphic Design License Plate Account to increase grants to local art agencies; and (2) an ongoing budget cut of \$124,000 to address the General Fund shortfall. The cut would result in the elimination of a currently vacant position, operating expense reductions, and a reduction in General Fund grants for local art projects.

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**Staff Recommendation:** Approve the budget, including the BCP and the proposed reduction.

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**Item 8820 COMMISSION ON THE STATUS OF WOMEN**

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**ISSUE 1: BBR AND BCP PROPOSALS**

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The Subcommittee considered these issues at its March 25<sup>th</sup> hearing and the items were held open pending further review and the May Revision.

The Governor's Budget proposes expenditures of \$531,000 (\$529,000 General Fund and \$2,000 reimbursements) and 4.6 positions, for a decrease of \$11,000. The administration submitted one BCP to add \$43,000 GF and 0.6 positions, but a proposed BBR of \$59,000 would result in the 0.6 position not being added plus an additional operating expense reduction of \$16,000 that would reduce travel and printing.

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**Staff Recommendation:** Reject the BCP and impose a 10% reduction of the current funding level, for a savings of \$54,000 General Fund.

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## ITEMS TO BE HEARD

### ITEM 0860 STATE BOARD OF EQUALIZATION

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#### ISSUE 1: TAX GAP REDUCTION EFFORTS

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

The Subcommittee heard this request on April 15<sup>th</sup> and held it open, pending resolution of a number of issues.

***BOE Has Identified More Revenue.*** The Legislative Analyst's Office (LAO) had originally recommended rejection of several components of this request. The LAO raised concerns with some of the components having low revenue-to-cost ratios (specifically the LAO identified \$9.4 million in new expenditures that only provided \$15.4 million in new revenue in 2008-09 for a revenue-to-cost ratio of 1.6:1). However, the BOE has revised its revenue estimates using 2006-07 data instead of 2005-06 data and the revenue-to-cost ratios are up significantly. The BOE indicates that the 2006-07 period incorporates enhancements in staff training and improved collection and audit methodologies, which will be ongoing and are appropriate to use for the tax gap estimates.

The revised revenue estimates for the BOE Tax Gap proposal increase General Fund revenue by \$7.2 million in 2008-09 (plus \$3.5 million of local revenue). In addition, BOE has increased its General Fund revenue estimate for the Agricultural Inspection Station Program (approved on the April 15<sup>th</sup> Consent List) by \$1.7 million (plus \$800,000 of local revenue). Together, these revised estimates increase General Fund revenue in 2008-09 by \$8.9 million above the May Revision.

**LAO Revised Recommendation.** Based on the revised revenue estimates from BOE, the LAO has modified their recommendations to approve all components of this request except with respect to the request for \$351,000 and 3 positions for the Non-Filers and Tax Evaders Discovery Research component. These staff would perform research and survey work to develop procedures and leads to investigate, to narrow the tax gap for (1) internet sellers, (2) itinerant vendors, and (3) cash-based businesses. No revenue is scored for this effort, but BOE hopes this discovery research would result in future tax gap initiatives. LAO recommends only approving 1.0 position to narrow the tax gap for internet sellers because that is where LAO believes the best opportunities lie (reduction of 2 positions and \$232,000).

#### COMMENTS

**More Realistic Salary Savings Level should be Budgeted.** BOE indicates that in March it had 49 vacancies (including leaves of absence) in excess of budgeted salary savings—a modest number, given the size of BOE, but there nevertheless. Furthermore, BOE is requesting \$10.6 million (General Fund) for additional positions in 2008-09. Many of the requested new positions have July 1, 2008 start dates and only a normal ongoing salary savings rate of 5 percent is budgeted for them. While staff anticipates that BOE will make every effort to hire staff rapidly, and that it will be largely successful, it would appear to be prudent to budget salary savings more realistically. For example, a General Fund savings of \$660,000 would result from an average 3-week delay in hiring the new positions. This very modest additional level of savings (in a \$242 million General Fund budget) is virtually certain to occur "on the natural" from a combination of factors—some delay in filling a portion of the new positions, ongoing excess vacancies, and potential delay in budget enactment. Staff also notes that BOE was not subjected to any Budget Balancing Reductions.

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#### Staff Recommendation:

Approve the revised LAO recommendation (approve the entire Tax Gap request except 2 positions (savings of \$232,000)).

Reduce BOE's budget by \$660,000 (General Fund) due to a more realistic projection of salary savings.

Score \$8.9 million of additional General Fund revenue due to revised estimates.

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**ITEM 1730                      FRANCHISE TAX BOARD**

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**ISSUE 1: TAX GAP PROPOSALS--SALARY SAVINGS**

On April 15<sup>th</sup>, the Subcommittee approved the Franchise Tax Board's (FTB's) Governor's Budget Tax Gap proposals, additional April Finance Letter proposals and an additional LAO proposal to reduce the tax gap. In addition, the consent agenda for today's hearing includes an additional 16 positions for filing enforcement workload. In total, these requests will add more than 160 positions to the board's staff.

While staff anticipates that FTB will make every effort to hire staff rapidly, and that it will be largely successful, it would appear to be prudent to budget salary savings more realistically. For example, a General Fund savings of \$900,000 would result from an average 3-week delay in hiring the new positions. This very modest additional level of savings (in a budget of more than \$560 million General Fund) is virtually certain to occur "on the natural" from a combination of factors—some delay in filling a portion of the new positions, a few excess vacancies in ongoing staff, and potential delay in budget enactment. Staff also notes that FTB was not subjected to any Budget Balancing Reductions.

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**Staff Recommendation:** Reduce the FTB budget by \$900,000 (General Fund) to recognize a more realistic estimate of salary savings.

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**ISSUE 2: MANDATORY E-PAY**

On April 15<sup>th</sup>, the Subcommittee heard this request and held it open pending a formal request from the administration to include the necessary statutory changes as budget Trailer Bill language. The administration now has made that request.

**BACKGROUND**

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

**COMMENTS**

***Senate Approved with Modifications.*** Senate Budget and Fiscal Review Subcommittee 4 approved the staffing and funding request and adopted placeholder Trailer Bill Language that (1) reduces the penalty for not paying electronically from 10 percent to 1 percent and (2) adds a pay-by-phone option.

A 1-percent penalty still would more-than-offset any interest loss due to a delay in the deposit of a timely-mailed payment. Late payments would remain subject to existing interest and penalties. Pay-by-phone would allow another option for those who may not have set up e-pay accounts.

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**Staff Recommendation:** Approve the request with the Senate modifications.

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**ISSUE 3: MAY REVISION—ACCELERATION OF LLC FEE PAYMENTS**

The Administration requests adoption of budget Trailer Bill language to accelerate the payment of Limited Liability Corporation (LLC) fees to produce a General Fund revenue gain of \$360 million in 2008-09. The revenue gain would be primarily one-time, but ongoing revenue annual gains of about \$35 million would result as the tax base grows. The proposal would accelerate the fee payment due date from April 15 of the *following* tax year to June 15 within that tax year (an acceleration of 10 months). The penalty for underpayment of the estimated fee would be 50 percent of the amount of the underpayment. However, the language contains a safe-harbor provision that waives any penalty if the estimated payment at least equals the amount of the fee due for the prior tax year. No penalty revenue is scored with this proposal.

**Background.** Current law imposes LLC fees (taxes) ranging from \$900 (for income between \$250,000 and \$500,000) to \$11,790 for incomes over \$5.0 million. This change would treat LLC fee taxpayers like most other tax filers, such as C Corporations and personal income taxpayers that must generally pay the bulk of their estimated tax liabilities (either through estimated payments or withholdings) during the tax year.

**COMMENTS**

- Because LLC fees are relatively fixed amounts and relatively small, compared with corporate or personal tax liabilities, it should be reasonably straightforward to estimate them.
- The Administration's draft language is similar to that of AB 1546 (Calderon).

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**Staff Recommendation:** Deny the BBR – Approve the May Revision proposal.

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**ISSUE 4: FINANCIAL INSTITUTION RECORD MATCH (FIRM)**

The FTB board has approved a proposal for a statutory change to improve the collection of delinquent tax accounts by having financial institutions match their account records against information about delinquent taxpayers. The board estimates that this proposal, if adopted as budget Trailer Bill legislation, would increase General Fund revenue by \$30 million in 2008-09 and grow to \$100 million annually by 2011-12.

The FTB indicates that of the three largest sources of asset data that could be used for collection of unpaid tax debts--real property records, wage and payment reporting, and financial institution accounts--the department lacks access only to financial institution account information.

**Proposal.** The FIRM proposal would require financial institutions doing business in California to match information on delinquent income tax and non-tax debtors against customer records on a quarterly basis. This proposal would result in the processing of data for approximately 1.6 million tax debtors. Financial institutions without the technical ability to process the data exchange or without the ability to employ a third-party data processor to process the match could opt to forward a file containing customer data to FTB to match against delinquent income tax and non-tax debtor records.

**Cost of Implementation.** The FTB estimates a one-time cost of \$7.6 million to program, develop, and test a new financial institution record match system for income tax and non-tax debt administration. Additionally, to ensure that existing collection processes can handle the increased volume of data expected under this proposal, modifications to core processes would be required. Staff estimates on-going annual costs of \$2.3 million to maintain the system and process the data matches. This proposal would impact core functions in the collection system and would require system programming, development, and testing to ensure successful integration. Increased workloads would require staff augmentation of approximately 36.2 Personnel Years for the development phases and 26.7 Personnel Years for the ongoing workload.

**BACKGROUND**

Current federal law mandates the Financial Institution Data Match (FIDM) program for the collection of delinquent child support debts. This process involves the matching of child support obligors with financial institution customer records in order to identify and levy the funds belonging to the obligors. Federal law prohibits the information received through FIDM to be used for any purpose other than child support collection. Current state law prohibits FTB from collecting against taxpayers with income tax debts that also have child support debts.

Under federal and state law, every individual, partnership, limited liability company, bank, corporation, estate, trust, or other organization engaged in a trade or business is required to file information returns to report various types of non-payroll compensation and other miscellaneous income. The types of transactions reported on the information return include, among other things, payments of interest, dividends, and certain gambling winnings. The filing requirements and dollar reporting thresholds vary and are generally contingent on the reporting requirements for the state in which the form 1099 recipient resides.

The California Right to Financial Privacy Act (the Act) prohibits financial institutions from disclosing confidential account records, unless certain exceptions are met. Criminal search warrants and subpoenas are two examples of exceptions. Current law provides that the Act supersedes any law that appears to violate the provisions of the act, unless that other law specifically provides that the Act does not apply to that particular law.

Current state law authorizes FTB to use several collection tools in order to collect delinquent tax liabilities, one of which is an Order to Withhold (OTW). An OTW can be issued to any third person in possession of funds or properties belonging to the debtor. Upon receipt of an OTW, the recipient notified is required to freeze the taxpayer's assets in their possession and hold those assets for ten days, and then remit to the department all cash or cash equivalents held that will satisfy the amount of the OTW. If the recipient of the OTW is in possession of any assets other than cash or cash equivalents, they must hold that item, notify FTB, and await further instructions.

Under current state tax law, FTB is prohibited from disclosing any confidential taxpayer information unless specifically authorized by law.

**COMMENTS**

- Approval of this proposal as placeholder TBL would move this issue to Conference and allow time for review by the LAO and Department of Finance.
- Based on the FTB estimates, the fiscal effect of this measure would be a net GF gain of \$22.4 million in 2008-09, growing to almost \$100 million annually in several years.
- The placeholder TBL should extend the program to include record matches for delinquent accounts held by the state's other two major tax agencies—the Board of Equalization and the Employment Development Department. FTB would coordinate and consolidate the data requests and be the point of contact for the matching operation with the financial institutions in order to avoid duplication and to enhance information sharing and collection efficiency among the three agencies.

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**Staff Recommendation:** Adopt the FIRM proposal (including BOE and EDD as noted in the comment above) as placeholder TBL.

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**ISSUE 5: COURT-ORDERED DEBT PROGRAM—UNPAID BAIL**

The Administrative Office of the Courts (AOC) requests adoption of clarifying budget Trailer Bill language to ensure that the courts and the counties are able to collect unpaid bail amounts.

Currently, courts have explicit statutory authority to send unpaid bail amounts to the FTB's Tax Intercept Program (FTB-TIP), but the statute is silent as to whether courts may send similar amounts to the FTB's Court-Ordered Debt Program (FTB-COD). Amounts collected by FTB-TIP are collected by intercepting the individual's tax refund. Amounts collected by FTB-COD are collected from wages or bank accounts. Because both programs are intended to authorize courts to send cases to FTB for collection, and because there is no apparent basis (either in legislative history or court practice) for allowing certain debts to be collected by FTB-TIP but not FTB-COD, a clarifying amendment is needed to explicitly authorize referrals of unpaid bail amounts to the FTB-COD program for unpaid bail amounts.

**COMMENTS**

- Both FTB and DOF have reviewed the proposed clarification and they indicate that it is appropriate and will not result in any state cost.

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**Staff Recommendation:** Approve the TBL.

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**ITEM 8855                      COMMISSION ON STATE MANDATES****ISSUE 1: MAY REVISION MANDATE PAYMENT PROPOSALS**

The January Governor's Budget proposed expenditures of \$142.6 million (\$140.7 million General Fund) and 12.0 positions (a decrease of 1.0 position). The Budget also reflects the proposal, which was adopted in the Special Session, to discontinue the practice of paying estimated claims, and only pay claims once the full-year's cost has been incurred and filed with the State. This action reduced General Fund costs by \$75 million in 2008-09 by shifting payment of 2007-08 claims to 2009-10. Post Proposition 1A, the State generally is required to pay past mandate claims of local governments unless it suspends a mandate. The budget includes \$64.0 million General Fund for this purpose. Proposition 1A also requires the repayment of all pre-July 1, 2004, mandate claims over a number of years (statute has established a 15-year period). The budget includes \$75 million (General Fund) to pay a portion of the remaining \$900 million in outstanding pre-July 1, 2004 mandate claims of local governments.

**May Revision Proposal to Defer Repayment**

In a May Finance Letter, the Administration requests to defer payment of \$75 million (General Fund) from 2008-09 to 2009-10 for the annual payment of pre-July 1, 2004 mandate claims. Full payment of these old claims is statutorily required by fiscal year 2020-21. The Administration believes that this deferral is allowable under the Constitution and would result in 2008-09 General Fund savings of \$75 million. The proposal would make up the skipped payment by making a double payment in 2009-10.

**Timely Claims for Ongoing Mandates Are Less Than Budgeted**

Both the Administration and the LAO indicate that the \$64 million (General Fund) currently budgeted to pay ongoing mandate claims (separate from the Pre-July 2004 costs), is over-budgeted by about \$27 million due to new analysis from the Commission (actual costs are lower than budgeted). Additionally, the LAO notes there \$25.5 million of the \$64 million budgeted appropriation is for two "new" mandates that will not go before the commission until June. As such, their costs are not due and payable by the state yet, and they have not yet been reviewed by the LAO. Therefore, only \$11 million of the \$64 million included in the budget is needed to pay timely claims for ongoing mandates. A budget reduction of \$53 million would be appropriate.

**Mandate Reconsideration Trailer Bill Language**

LAO and DOF also recommend adoption of budget Trailer Bill language to require the Commission on State Mandates to reconsider its previous mandate decision regarding the Sexually Violent Predator Program. LAO and DOF point out that these laws may now be included within the scope of Jessica's Law, which was approved by the voters in 2006. If the commission determines that is the case, then state reimbursement of local costs would no longer be required because this mandate would be voter-imposed. Such a finding would not change the requirement to carry out the Sexually Violent Predator Program.

**COMMENTS**

The LAO also continues to recommend repeal of the Animal Adoptions mandate, for a savings of \$5 million in 2008-09 and larger amounts in subsequent years.

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**Staff Recommendation:**

Approve May Revision deferral of \$75 million payment for past mandate costs.

Reduce the General Fund appropriation for ongoing mandate claims by \$53 million.

Adopt the Trailer Bill language for reconsideration of the Sexually Violent Predator Program mandate

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**ITEM 9100 TAX RELIEF**

The Subcommittee last heard this item on April 15<sup>th</sup> and held it open.

**ISSUE 1: SENIOR HOMEOWNERS AND RENTERS PROGRAMS**

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

**LAO Recommendation.** LAO recommends rejection of the Governor's 10-percent across-the-board approach and instead recommends an alternative that results in similar budget savings, but shifts the impacts away from the lowest-income taxpayers. The LAO recommends that the Renters' Program and Property Tax Deferral Programs be left whole, and instead the Property Tax Assistance program income limits be rolled back from \$42,800 to \$33,000 and reduce all remaining homeowner payments by 45 percent (to the 1999-00 levels). This would result in savings of \$18.5 million (versus the \$21.6 million in the Governor's Proposal).

**BACKGROUND**

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

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

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

**COMMENTS**

The LAO approach, while holding renters harmless, would have a significant impact on all of the 140,000 homeowner recipients. Those with incomes over \$33,000 (about 11,000 claimants) no longer would receive any benefit, while all other homeowner claimants would see their benefit cut almost in half.

**Staff Alternative**

Staff proposes an alternative approach that would apply a flat dollar reduction to all of the assistance payments in each program. The amount of the dollar reduction would be equal 8.5 percent of the maximum grant in each program--\$40 in the homeowners' program and \$29.50 in the renters' program. This approach results in the same savings total for the two programs as assumed in the Governor's Budget, and has the following features:

1. Compared with the LAO alternative, homeowner payments would be cut by only 8.5 percent versus 45 percent--a difference of \$100 to \$150 to the lower-income homeowners. Compared with the Governor, senior homeowners below about \$13,000 annual income would have smaller reductions
2. Payments to senior renters with household incomes below about \$14,000 would be cut less than they would in the Governor's 10-percent cut.
3. The number of homeowner households that would no longer qualify for a payment would be about 11,000 (out of 140,000)—the same as in the LAO alternative. About 3,500 renters (out of 460,000) would no longer receive a payment.
4. The Governor's 10-percent reduction to the property tax deferral program would be retained.

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**Staff Recommendation:**

Approve the staff alternative. Authorize DOF and FTB to fine-tune the calculations to ensure the same savings as the Governor--\$21.6 million).

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**ISSUE 2: OPEN-SPACE SUBVENTIONS**

The Subcommittee last heard this item on April 15<sup>th</sup> and held it open.

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

**LAO Alternative**

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

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**Staff Recommendation:** Approve the Governor's 10-percent reduction.

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**ITEM 9210            LOCAL GOVERNMENT FINANCING**

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Note: Criminal Justice-related components of this item will be heard separately.

**ISSUE 1: DISASTER PROPERTY TAX RELIEF**

This budget item funds tax relief to homeowners and local governments impacted by specified natural disasters. For example, SB 38 (Ch 22, St of 2007) provides specified property tax relief to individuals and local governments for property damage caused by wildfires in Riverside County. The Governor proposes a 10-percent reduction in this item for savings of \$88,000.

**COMMENTS**

The Administration indicates that this reduction would not impact any property owners or local governments, because they would still be entitled to related benefits even in excess of the appropriated amount. In recent years a significant amount of the budget Act appropriation for similar legislation has been unclaimed and reverted to the General Fund as savings.

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**Staff Recommendation:** Approve the Governor's reduction.

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**ISSUE 2: SPECIAL SUBVENTIONS TO REDEVELOPMENT AGENCIES**

This budget item funds State subventions to Redevelopment Agencies (RDAs) to backfill revenues they lost in the 1980s. These redevelopment subventions were instituted after the State eliminated personal property tax supplemental subventions to redevelopment agencies. The current subventions were intended to ensure that redevelopment agencies would not default on bonds that had been backed with personal property tax subvention revenue. The funds are only provided to RDAs that were in existence when the tax was eliminated, and only is provided to those RDAs that need the funds to cover bond indebtedness costs. The Governor proposes a 10-percent reduction in this item for savings of \$100,000 (reducing the budget from \$800,000 to \$700,000).

**COMMENTS**

- The Department of Finance indicates the base funding of \$800,000 ties to actual expenditures in 2002-03. The Controller indicates that actual expenditures in 2006-07 were only \$547,000 and only four RDA qualified. The State Controller's Office indicates that only one RDA submitted a qualifying request for payment in the first half of 2007-08 (\$265,000 to Huntington Park).
- Budget bill language allows the Director of Finance to authorize expenditures in excess of the amount appropriated in this item, to the extent necessary to fund all qualifying payments with 30 day notification to the Legislature.
- Budget Bill language also limits expenditures to amounts needed for debt payments that exceed other revenues available to an RDA.

Given that the actual 2006-07 payment was only \$547,000, and since then it appears the number of qualifying RDAs has fallen from four to one, it may be reasonable to reduce the appropriation to \$500,000. This would result in additional budgeted General Fund savings of \$200,000. Staff Recommendation: Reduce funding to \$500,000 based on the 2006-07 actual cost and staff analysis of the Controller's data for the first half of 2007-08.

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**Staff Recommendation:** Reduce to \$500,000 (\$200,000 below Governor).

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**ISSUE 3: REDEVELOPMENT AGENCIES—COMPLIANCE WITH PASS-THROUGH REQUIREMENTS**

A recent audit by the State Controller's Office found that, contrary to the requirements of law, some redevelopment agencies (RDAs) are not making pass-through payments to K-14 districts and some K-14 districts are not properly reporting their pass-through payments to the state. As a result, property tax revenues to K-14 education have been understated because (1) many RDAs did not make the required pass-through payments and (2) often when RDAs did make pass-through payments, they were not properly identified and reported as property tax revenue by K-14 districts. The understatement of K-14 property tax revenues has resulted in additional state General Fund costs to meet the funding requirements of Proposition 98 and school revenue limits.

The LAO alternative budget includes three recommendations to address this issue. LAO estimates that these changes would reduce state education costs by about \$98 million in 2008-09 and by somewhat lower amounts annually thereafter. These changes also would benefit K-14 districts and other local entities by ensuring that they receive pass-through revenues to which they are entitled under state law.

**Background**

Under current law, if a community finds that it has an urban area with serious physical and economic blight, it may create a redevelopment project area. Once a project area is established, the county auditor annually allocates all growth in property taxes due to increases in assessed value within the project area (known as tax increment revenue) to the community's redevelopment agency. Accordingly, tax increment revenues are property tax revenues that are diverted from schools and local governments to RDAs in order to finance redevelopment.

According to the LAO, statewide, California cities and counties have created more than 420 redevelopment agencies and more than 750 project areas. Because project areas typically are large (often encompassing more than 500 acres) and last for decades, the tax increment revenue that redevelopment agencies receive comprises a significant share of statewide property taxes. In 2008-09, LAO estimates that California RDAs will receive about \$4.9 billion of tax increment revenue, about 11 percent of total property taxes.

***RDA Pass-Through Requirements.*** State law places a number of restrictions and conditions on RDAs' use of tax increment revenues. Each RDA must deposit 20 percent of its tax increment revenues into a local Low and Moderate Income Housing Fund and use these funds to provide affordable housing. Redevelopment agencies also must return a portion of their tax increment revenues to other local agencies as "pass-through" payments.

***A Portion of the Pass-Through Must Be Reported as K-14 Property Tax Revenue.*** Any school district or community college district that receives pass-through payments from a redevelopment project created after enactment of the Community Redevelopment Law Reform Act of 1993 (“AB 1290”) or amended pursuant to SB 211 must report a portion of these payment as an offset to state apportionments. For K-12 districts, the portion of their pass-through payment that offsets state apportionments is 43.3 percent. For community college districts, the portion is 47.5 percent. In essence, the state allows K-14 districts to retain more than half of these pass-through tax increment revenues as a supplement to their normal funding, with the state General Fund making up the difference through school apportionments and Proposition 98 funding.

### **LAO Recommendations**

LAO makes the following recommendations to correct the past payment and reporting errors for RDA pass-throughs and to improve ongoing compliance:

***Five Year RDA Recapture Provision (About \$50 million in 2008-09).*** LAO recommends enactment of budget trailer legislation directing RDAs and county auditors to jointly calculate (for each project area created after AB 1290 or amended pursuant to SB 211) the amount of pass-through payments that the RDA (1) should have provided and (2) actually made to each local agency over the last five years. The RDAs and county auditors will submit this report to the Legislature, State Controller, Department of Finance, and all affected local agencies by September 15, 2008 and shall provide an updated report by March 15, 2009 and every six months thereafter as long as there are any outstanding pass-through liabilities for this period.

If the September 15, 2008 pass-through report indicates that an RDA has an outstanding pass-through payment obligation, it would be required to those amounts to each local agency by November 1, 2008.

***Enforcement Mechanisms.*** In order to ensure compliance with the recapture provision, LAO proposes including several enforcement provisions in the trailer legislation. Until an RDA's past pass-through obligations (if any) have been satisfied (as confirmed by the county auditor), a redevelopment agency could not amend or create a redevelopment plan or add debt to its Statement of Indebtedness. Starting in November 2008, interest would accrue on any outstanding pass-through payment obligation at a rate equal to twice the Pooled Money Investment Account rate. Because the recapture payments are not new obligations, they could not be designated as additional RDA debt to extend the life of any redevelopment project or increase the amount of debt used to determine the amount of tax increment revenue that an RDA may receive. County auditors would be reimbursed by RDAs for costs incurred by them to carry out these tasks.

**Accounting and Reporting.** In the case of K-14 education, instead of depositing the full amount with the district, the redevelopment agency shall deposit to the county ERAF 43.3 of any amount owed to a K-12 district and 47.5 percent of any amount owed to a community college district.

**Five-Year K-14 Recapture (estimated \$20 million annually).** In order to correct underreporting or misreporting by K-14 districts of pass-through payments to the state over the last five years, LAO recommends a temporary increase in the portion of future pass-through payments counted as property tax revenue (and deposited into ERAF, as discussed below) for those districts. The increase would be from 43.3 or 47.5 percent to 80 percent until such time as the amount of underreporting has been offset.

If a K-14 district would incur significant hardship associated with this temporary change, LAO proposes that the districts, with the assistance of their county office of education, propose an alternative schedule for correcting the underreporting.

**Simplify and Improve the Accountability of the Pass-Through Mechanism (\$28 million annually).** LAO recommends the following statutory changes to greatly simplify the pass-through process:

1. **Place Responsibility with County Auditors.** Shift the responsibility for calculating and making pass-through payments from redevelopment agencies to county auditors. This will centralize responsibility for these calculations and payments in the county official generally responsible for property tax allocations. Furthermore, this will facilitate oversight by the State Controller's Office since the office already works closely with county auditors regarding property tax allocation.
2. **Use ERAF to Simplify Payments and Reporting.** Require county auditors to deposit into their county Educational Revenue Augmentation Fund (ERAF) the portion of RDA pass-throughs that must be reported as K-14 property tax revenue. Placing this portion of the payments directly in ERAF, where they directly offset state apportionment and Proposition 98 costs, avoids relying on the individual K-14 districts to allocate, record and report their pass-through payments accurately (especially since they may receive several types of pass-through payments subject to different rules and not always properly identified by the RDA). County auditors would pay the supplemental funding portion of the pass-throughs to the K-14 districts. In the case of basic aid (or "excess tax") K-14 entities, they would receive additional payments from ERAF to the extent that their pass-through payments were deposited to ERAF.

**COMMENTS**

- This issue has been brought to the attention of Subcommittee 2. However, the specific responsibilities and tasks that would be imposed by the proposed trailer legislation affect redevelopment agencies and county auditors—entities of local government that are within the jurisdiction of Subcommittee 4.
- LAO has presented a detailed roadmap to the resolution of this problem, particularly given the brief amount of time since the State Controller's audit was released. However, additional discussions should take place with the State Controller's Office, Department of Finance, redevelopment agencies, county auditors, and the education community regarding the specific features of this approach. Consequently, staff recommends adopting the LAO recommendations as placeholder trailer bill language, to move this issue forward to Conference, and score an initial estimate of \$98 million of General Fund savings.

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**Staff Recommendation:** Adopt placeholder TBL and score \$98 million of General Fund savings.

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**ITEM 9350 SHARED REVENUES**

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The 9350 display in the Governor's Budget shows various statutory apportionments of funds that the state shares with local governments. Of the amounts displayed in this budget item, \$12.3 million is General Fund and \$2.1 billion is special funds and federal funds. The Administration proposes budget trailer bill language to implement 10-percent reductions for the two General Fund apportionments.

**ISSUE 1: APPORTIONMENT FOR TRAILER VEHICLE LICENSE FEE**

This budget item apportions revenue to cities and counties that lost Vehicle License Fee (VLF) revenue when the state converted from an un-laden weight system to a gross vehicle weight system for purposes of assessing VLF for commercial vehicles. This change conforms to the International Registration Plan, a reciprocity agreement among US states and Canada for payment of commercial license fees based on distance operated in each jurisdiction. Existing law provides a General Fund allocation of \$11.9 million to replace VLF allocations to local governments that were lost when the registration fee mechanism was changed. This funding is deposited in the Local Revenue Fund to support local health and welfare program costs that were shifted to local governments as a result of Realignment in the early 1990s. The Governor proposes a \$1.2 million cut (10 percent) to this \$11.9 million backfill apportionment. This apportionment is entirely separate from, the VLF/Property Tax Swap that shifted property tax to cities and counties to backfill for the VLF rate reduction.

**COMMENTS**

Realignment represents an agreement between the state and local government that shifted certain functions and funding responsibilities to counties along with specific funding streams (most of the remaining VLF and a half-cent sales tax increment). This shared revenue amount is part of that arrangement. Reductions in Realignment revenues should be offset by reduction in county financial responsibility. The Governor's proposed reduction lacks such an offset.

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**Staff Recommendation:** Deny the BBR (restore \$1.2 million GF).

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**ISSUE 2: APPORTIONMENT OF TIDELANDS OIL REVENUE**

This apportionment consists of 1 percent of the revenue received by the State from leases of publicly owned coastal waters for oil extraction, to local governments in whose jurisdiction the extractions are occurring. Statute requires that the amounts paid to cities and counties shall be deposited in a special tide and submerged lands fund to be held in trust and to be expended only for the promotion and accommodation of commerce, navigation, and fisheries, for the protection of lands within the boundaries of the cities and counties, for the promotion, accommodation, establishment, improvement, operation, and maintenance of public recreational beaches and coastlines, and the mitigation of any adverse environmental impact caused by exploration for hydrocarbons. The Governor proposes a \$46,000 cut (10 percent) to this \$462,000 apportionment.

**COMMENTS**

This apportionment provides a very small amount of funding to local communities that may be impacted from State leases of offshore waters for oil extraction. However, little new state leasing activity has occurred for many years. Given the severe General Fund situation, the Subcommittee may want to eliminate this discretionary revenue sharing with local governments – this would result in General Fund savings of \$416,000 beyond the Governor’s proposal.

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**Staff Recommendation:** Eliminate the apportionment (conform with the Senate).

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