

**LAO**   
65 YEARS OF SERVICE

2006-07 Analysis



# MAJOR ISSUES

## *General Government*

---



### **Continuing Concerns With Help America Vote Act (HAVA) Implementation**

- The Secretary of State (SOS) has provided few details on the department's proposed implementation of HAVA. Based on the information received to date, however, we have a number of serious concerns with the agency's approach. Delays by SOS over the past year in implementing components of the state's HAVA plan have impaired counties' ability to acquire and install HAVA-compliant equipment for the upcoming June 2006 primary election. In addition, SOS's proposal for a statewide voter registration database exposes the General Fund to millions of dollars in costs, despite the state having received over \$350 million in HAVA funds. We withhold recommendation on SOS's HAVA expenditures pending the submittal of detailed justifications (see page F-43).



### **Delete Midyear Reduction Authority for More Honest Budgeting**

- The Governor's budget assumes that proposed authority for the administration to reduce departmental budgets during the year will decrease overall state costs by \$258 million. Since 2002-03, enacted budgets have included similar provisions. In reality, however, the full magnitude of these savings is rarely achieved. We recommend that the Legislature delete the proposed authority. The administration should identify any *specific* proposed savings in departmental budgets during the spring budget process (see page F-118).



### **Income Tax Credits Warrant Careful Scrutiny**

- The Franchise Tax Board (FTB) administers two tax programs with significant revenue implications: (1) the child

and dependent care expense credit, which is a refundable tax credit available to eligible taxpayers who have expenses associated with children or other dependents, and (2) the enterprise zone hiring credit, which is available to businesses operating in certain geographic areas who hire certain qualified individuals. A number of significant administrative issues have been raised regarding both of these programs, and we recommend that FTB adjust its compliance and enforcement resources accordingly (see page F-54).



### **Budget Understates Mandate Costs**

- The Governor's budget includes \$240 million (General Fund) and \$1.7 million (special funds) to pay noneducation mandate claims from local governments. We review this budget proposal and find that the funding will not be sufficient to fully cover all mandate obligations in 2006-07. We make a series of recommendations in order for the Legislature to address these costs (see page F-91).



### **Reject More Autopilot Spending From the Administration**

- The administration proposes to switch the Governor's Office budget from traditional budgeting to an automatic annual adjustment. The change would cost about \$1 million annually. The administration has offered no policy reason why the current process is not working. We therefore recommend that the Legislature reject the proposal to put the Governor's Office budget on autopilot spending (see page F-13).



### **Companion Publication: Emergency Preparedness and Retiree Health**

- In "Part V" of the companion publication *The 2006-07 Budget: Perspectives and Issues*, we discuss two additional general government issues facing the Legislature—emergency preparedness and retiree health costs. Regarding emergency preparedness, we analyze the Governor's proposals and offer key legislative considerations. Regarding health care costs for retired public employees, we discuss why governments face rising costs to provide these benefits and steps the Legislature can take to address the costs.

# TABLE OF CONTENTS

## *General Government*

---

<b>Overview</b> .....	F-7
<b>Departmental Issues</b> .....	F-13
Governor’s Office (0500) .....	F-13
Secretary for Business, Transportation, and Housing (0520) .....	F-16
Office of Emergency Services (0690) .....	F-19
Department of Insurance (0845).....	F-23
California Gambling Control Commission (0855).....	F-26
Board of Equalization (0860) .....	F-31
Secretary of State (0890) .....	F-43
Franchise Tax Board (1730) .....	F-53
State Personnel Board (1880) .....	F-65
Department of Technology Services (1955) .....	F-67
Department of Alcoholic Beverage Control (2100).....	F-69
Employment Development Department (7100) .....	F-71

Department of Industrial Relations (7350) .....	F-76
Department of Personnel Administration (8380) .....	F-78
California Horse Racing Board (8550).....	F-83
California Department of Food and Agriculture (8570) .....	F-86
Department of Finance (8860) .....	F-89
Commission on State Mandates (8885).....	F-91
Department of Veterans Affairs and Veterans' Homes of California (8950-8966).....	F-102
Local Government Financing (9210) .....	F-104
Health and Dental Benefits For Annuitants (9650) ..	F-107
Employee Compensation (9800) .....	F-110
Midyear Budget Reductions (Control Sections 3.45, 4.05, and 4.06).....	F-118
Retirement Contributions (Control Section 3.60) .....	F-121
<b>Findings and Recommendations</b> .....	<b>F-127</b>

# OVERVIEW

## *General Government*

---

**T**otal state funding for general government is proposed to decrease by about 7 percent in the budget year. This decrease primarily is due to the one-time payment of the vehicle license fee gap loan in the current year (partially offset by increases in many government programs). The largest proposed increases are for state employee compensation, health and dental benefit costs for state retirees, and mandate payments to local governments.

The “General Government” section of the budget contains a number of programs and departments with a wide range of responsibilities and functions. For instance, these programs and departments provide financial assistance to local governments, regulate businesses, provide services to state agencies, enforce fair employment practices, and collect revenue to fund state operations. The 2006-07 *Governor’s Budget* proposes \$7.5 billion in state expenditures (combined General Fund and special funds) for these functions. The proposed budget-year funding is \$531 million (6.6 percent) less than estimated 2005-06 expenditures. After adjusting for the one-time vehicle license fee (VLF) gap loan repayment of \$1.2 billion in 2005-06, the year-to-year change is an increase of \$656 million (10 percent).

## SPENDING BY MAJOR PROGRAM

There are three major program areas within general government:

- State administrative functions, which include a broad range of state departments.
- Tax relief and local government payments.
- State employee compensation, which funds many of the costs of current and former employees.

We describe these program areas below, and Figure 1 (see next page) shows the estimated 2005-06 and proposed 2006-07 expenditures by program area.

**Figure 1****General Government Spending by Program Area***(All Funds, In Millions)*

Program	Estimated 2005-06	Proposed 2006-07	Difference	
			Amount	Percent
State administration	\$3,500	\$3,496	-\$4	-0.1%
Tax relief/local governments	2,385	1,442	-943	-39.5
State employee compensation <sup>a</sup>	2,130	2,545	415	19.5
<b>Totals</b>	<b>\$8,014</b>	<b>\$7,483</b>	<b>-\$531</b>	<b>-6.6%</b>

<sup>a</sup> Costs not reflected in departments' budgets.  
Note: Totals may not add due to rounding.

**State Administration**

Within general government, there are about 50 departments and agencies that serve a wide range of functions. Departments provide services to the public, regulate businesses, collect tax revenues, and serve other state entities. For many state departments, the Governor has proposed increased levels of expenditures in the budget year. Overall spending is proposed to stay roughly the same at \$3.5 billion. A number of proposed augmentations offset the decrease in spending caused by one-time expenses in 2005-06 (such as costs for the special election and wildfires).

**Government Services.** A number of departments provide government services to the public. These services include housing assistance, coordination of emergency responses, and assistance to veterans. In a number of areas, the administration proposes increased funding:

- The reinstatement of Cesar Chavez education grants. These grants have been suspended for the past three years. The proposal restores the funding to \$5 million from the General Fund.
- The expansion of services offered by the Department of Veterans Affairs. The largest proposal is to establish a new Alzheimer's unit at the Yountville home. In total, the budget proposes a \$10 million, or 15 percent, increase in the department's General Fund budget.
- The augmentation of \$2.7 million to the state's General Fund contribution to the Tourism Commission. The proposal would bring the total state contribution to \$10 million annually.



---

**Regulatory Activities.** Many departments are responsible for providing regulatory oversight of various consumer and business activities. These agencies protect the consumer and promote business development while regulating various aspects of licensee, business, and employment practices. The groups regulated range from individuals licensed to practice specified occupations to large corporations licensed to conduct business in the state. Most of these departments are funded from special funds that receive revenues from regulatory and license fees. Among the Governor's proposals in this area are:

- The expansion of gambling regulatory activities at the California Gambling Control Commission. The \$2.9 million augmentation (various funds) is primarily related to tribal gambling.
- The expansion of the California Department of Food and Agriculture's efforts to combat threats to the food supply. The budget requests \$7.2 million from the General Fund for these purposes.

**Tax Collection.** The Franchise Tax Board (FTB) and the Board of Equalization (BOE) are the state's two major revenue collection agencies. In cooperation with the Employment Development Department, FTB is responsible primarily for collection and administration of the state's personal income tax and the corporation tax. In addition, it assists in the collection of various types of nontax delinquencies, including child support payments and vehicle-related assessments. The BOE is responsible primarily for administration and collection of the sales and use tax, as well as excise taxes on fuel, cigarettes, and alcoholic beverages. The budget proposes total funding of \$778 million (\$712 million General Fund) for these two agencies in 2006-07, down \$20 million (2.5 percent) from the current year. This decrease is due largely to a decline in FTB expenditures for the California Child Support Automation System.

**Services to Other Departments.** Some state departments exist primarily to provide support for other departments. For instance, the Department of General Services provides guidance to state departments on purchasing and real estate decisions. The Department of Finance acts as the state's fiscal oversight agency. Among the Governor's proposals are:

- The continued implementation of a new state payroll system at the State Controller's Office. The project will cost \$39 million (\$20 million General Fund) in 2006-07.
- The continuation of efforts to develop a new state budget information system. The project will cost up to \$5.6 million from the General Fund in 2006-07.

## Tax Relief and Local Government Payments

The state provides tax relief—both as subventions to local governments and as direct payments to eligible taxpayers—through a number of different programs. The major programs in this area are homeowners' property tax relief, various tax assistance programs for senior citizens, and open space property tax subventions. The state also makes payments to local governments for other programs, such as to reimburse local governments for state-mandated costs and to provide grants for public safety. The Governor's budget proposes to decrease General Fund payments in this area from \$2.1 billion to \$1.2 billion. This large decrease is due to the one-time VLF backfill loan repayment of \$1.2 billion in 2005-06. The loan repays local governments for a portion of the VLF backfill (to compensate them for rate reductions in the VLF) that they did not receive from the General Fund in 2003-04 due to budget considerations. Offsetting this reduction are increases in spending for mandate payments and public safety subventions.

## State Employment and Retirement

*Employment Agreements.* There are about 177,000 rank-and-file state employees (not including those in higher education) covered under state collective bargaining law. The pay, benefits, and working conditions for these employees are typically spelled out in memoranda of understanding negotiated between employee unions and the state. The Governor's budget proposes to appropriate \$382 million (\$203 million General Fund) to fund existing collective bargaining agreements with new costs in 2006-07, as well as other compensation-related costs. Among the largest component of these costs is for the final year of multiyear agreements with the California Highway Patrol and California Correctional Peace Officers Association, as well as their supervisors and managers (total costs of \$152 million, of which \$114 million is from the General Fund). By July 2, 2006, contracts for 18 of the state's 21 bargaining units will be expired. The budget does not include any funds for any potential costs associated with new agreements with these units.

*Retirement Costs.* The state contributes to the retirement of (1) state employees through the Public Employees' Retirement System and (2) public school teachers through the State Teachers' Retirement System. The state also pays for a portion of University of California (UC) retirement costs through the university's budget. Retirement-related expenditures (from the General Fund and various special funds) account for a significant part of state spending on an annual basis. In 2006-07, General Fund expenditures for public employee retirement-related costs (including UC costs) will total \$4.2 billion, as shown in Figure 2. One of the fastest grow-

ing components of state retirement costs has been for retirees' health and dental benefits. These costs are projected to exceed \$1 billion in 2006-07. (We discuss these benefits in more detail in "Part V" of *The 2006-07 Budget: Perspectives and Issues*.) The 2005-06 budget package assumed the issuance of pension obligation bonds, with a net benefit to the state's General Fund of \$525 million in 2005-06. Legal challenges have delayed the issuance of the bonds, and the Governor's budget does not assume that the bonds will be issued in the current or budget years.

**Figure 2****General Fund Costs for Retirement Programs***(In Millions)*

	Estimated 2005-06	Proposed 2006-07
<b>State Retirement Plans</b>		
Public Employees' Retirement Fund	\$1,336	\$1,366
Teachers' Retirement Fund	1,081	1,080
Judges' Retirement Funds	144	155
Defined Contribution Plans <sup>a</sup>	—	48
Subtotals	(\$2,561)	(\$2,649)
<b>Other Retirement Benefits</b>		
Health and Dental Benefits for Annuitants	\$895	\$1,019
Social Security and Medicare <sup>b</sup>	401	420
Subtotals	(\$1,296)	(\$1,439)
<b>University of California (UC) Retirement Programs</b>		
UC Retirement Plan	—	—
Health and Dental Benefits for UC Annuitants <sup>b</sup>	\$71	\$71
Subtotals	(\$71)	(\$71)
<b>Totals</b>	<b>\$3,928</b>	<b>\$4,159</b>

<sup>a</sup> State's contribution to supplemental retirement plan for correctional officers and their supervisors and managers.

<sup>b</sup> Legislative Analyst's Office estimates.



# DEPARTMENTAL ISSUES

*General Government*

## GOVERNOR'S OFFICE (0500)

This item provides the Governor with funds for his personal staff to coordinate the administration's operations. The Governor's budget proposes expenditures of \$18.4 million from the General Fund, an increase of less than 1 percent from estimated current-year expenditures. More than 87 percent of the Governor's Office budget is for personnel costs. The proposed budget would support 185 positions.

### **Automatic Budget Increases Unnecessary**

*We recommend that the Legislature reject the administration's proposal to automatically increase the Governor's Office budget annually. The administration has offered no policy rationale as to why the current process is not working. (Reduce Item 0500-001-0001 by \$71,000.)*

*Recent Budgeting for the Office.* Traditionally, the Governor's Office has been budgeted like other state departments. If the Governor's Office identifies a staffing problem, it can submit a budget change proposal to the Legislature seeking an augmentation. In addition, until 2004-05 the Governor "borrowed" many staff from other state departments to assist the office with its work. These positions often were borrowed for long periods of time. To better reflect the number of staff actually working in the Governor's Office, the Governor proposed and the Legislature approved in the 2004-05 Budget Act a permanent transfer of borrowed staff to the

Governor's Office. Consequently, the Governor's Office budget grew from \$6.1 million to \$18.4 million between 2003-04 and 2004-05. Likewise, the official staff count grew from 86 to 188 over the same time period.

***Proposed Automatic Adjustment.*** The administration proposes to switch the Governor's Office budget from traditional budgeting to an automatic annual adjustment. Specifically, beginning in June 2007, the office's budget would be increased annually by the percentage growth in the state appropriations limit (SAL). (The SAL grows annually by a population and cost-of-living factor.) Because the administration proposes this new policy to begin in the last month of the 2006-07 fiscal year, it would only increase the office's budget by \$71,000 in the budget year. If the SAL factor were applied to the budget for the entire year, the increased cost would be nearly \$1 million. As its rationale for the budgeting change, the administration points to similar growth factors for the legislative and trial court budgets. The only policy rationale offered by the administration for starting the SAL growth in June 2007 is that the start time relates to an agreement between the Department of Finance and the judiciary.

***Legislature's Annual Adjustment Was Accompanied by a Major Budget Reduction.*** In passing Proposition 140 in November 1990, the voters reduced the Legislature's budget by more than *one-third*. The measure also instituted a cap on the Legislature's appropriation amount. This cap grows annually by the SAL factor so that legislative expenses can increase with the economy over time—from the reduced base. (Proposition 140 also implemented other changes related to the Legislature, such as term limits and ending legislators' retirement benefits.) The administration does not propose an equivalent reduction in the Governor's Office budget (roughly \$6 million).

***Trial Court Funding Program Has Unique Issues.*** As part of the 2004-05 budget, a portion of the judicial branch budget—the Trial Court Funding Program—was placed under the SAL funding methodology similar to what is proposed for the Governor's Office. However, this was largely intended to provide trial courts with a rough idea of future resources during local employee compensation negotiations. This rationale does not apply in the case of the Governor's Office. In the "Judiciary and Criminal Justice" chapter, we discuss in detail the administration's 2006-07 proposal to expand the SAL funding methodology to the entire judicial branch budget.

***Reject Automatic Spending Increases.*** Like other state departments, the Governor's Office should propose spending increases based on staff workload. The administration has offered no evidence that current staffing in the Governor's Office is inadequate. In addition, the administration has offered no policy reason why the current process is not working. We

see no reason to put more of the state's budget on autopilot spending. We therefore recommend that the Legislature reject the proposal to automatically increase the Governor's Office budget each year.

=====

## SECRETARY FOR BUSINESS, TRANSPORTATION, AND HOUSING (0520)

The Secretary for Business, Transportation, and Housing oversees the following 14 departments that develop and maintain the state's transportation infrastructure, promote traffic safety, promote housing availability in the state, and regulate state-licensed financial entities as well as managed health care:

### *Business and Regulatory Departments*

- Alcoholic Beverage Control
- Financial Institutions
- Corporations
- Real Estate
- Office of Real Estate Appraisers
- Managed Health Care
- Office of Patient Advocate

### *Transportation Departments*

- Transportation
- California Highway Patrol
- Motor Vehicles
- Office of Traffic Safety
- High-Speed Rail Authority

### *Housing Departments*

- Housing and Community Development
- California Housing Finance Agency



In addition, the secretary's office also manages a number of economic development programs, such as the Infrastructure Bank, the Film Commission, the Small Business Loan Guarantee Program (SBLGP), and the Tourism Commission.

The budget requests \$29 million (and 60 personnel-years) for the secretary's operations in 2006-07. This represents a 13 percent increase over estimated current-year expenditures. The largest proposed augmentation is for the Tourism Commission, which we discuss below. The proposed budget includes \$16 million from the General Fund, with the remainder coming from a number of special funds and reimbursements. The budget also proposes to repay a 2002-03 loan from the SBLGP of \$10.7 million.

### **Tourism Marketing Augmentation Not Justified**

*We recommend that the Legislature reject the proposal to expand the state's General Fund subsidy of the tourism industry from \$7.3 million to \$10 million. The industry has not contributed its targeted share and the value of the subsidy is questionable. In addition, we recommend the adoption of budget bill language making the state's existing contribution contingent on industry making its targeted contributions. (Reduce Item 0520-001-0001 by \$2.7 million.)*

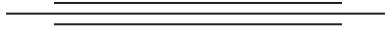
**Background.** The California Tourism Marketing Act (Chapter 871, Statutes of 1995 [SB 256, Johnston]) establishes the framework for the Tourism Commission, which provides domestic and international marketing of California as a tourism destination. The act creates a public-private funding model in which the state provides General Fund spending and the tourism industry provides funding through a voluntary assessment. The law establishes minimum annual funding targets—\$7.3 million from the state and \$25 million from the industry (a funding ratio of 23 percent to 77 percent). Neither the state nor industry, however, are obligated to provide funding. Due to budget constraints, the state did not make any contributions in 2003-04 or 2004-05. In those years, the industry provided roughly \$7 million in contributions. The *2005-06 Budget Act* provides \$7.3 million in General Fund support to the Tourism Commission, with industry assessments providing an additional \$11 million (a funding ratio of 40 percent to 60 percent).

**Proposal to Increase State Support.** The Governor's budget proposes a General Fund augmentation of \$2.7 million, to bring annual state support to a total of \$10 million. The industry has committed to maintaining 60 percent of total funding, which would raise its contribution to \$15 million.

***Proposal Does Not Meet Funding Ratio of Marketing Act.*** As noted above, state law establishes a minimum annual funding target of \$25 million from industry to match the state's contribution of \$7.3 million. The industry can voluntarily raise its contribution by vote.

***Industry Subsidy Questionable.*** The state's contribution to the marketing program is a subsidy of the state's tourism industry. The administration asserts that the state-funded marketing program generates additional state tax revenues. To date, however, we have not seen evidence that the subsidy actually significantly affects tourists' behavior on the margin.

***Recommend Rejecting the Administration's Proposal.*** Given the state's overall budget situation and the intent of state law, we recommend that the Legislature reject the administration's proposal to increase General Fund support for the tourism marketing program. In addition, we recommend the adoption of budget bill language making the \$7.3 million General Fund contribution contingent on the industry providing its targeted contribution level of \$25 million. If the industry determines that an expansion of the marketing program will provide the industry with cost-effective benefits, then it should be willing to fund the increase on its own.



## OFFICE OF EMERGENCY SERVICES (0690)

The Office of Emergency Services (OES) is responsible for assuring the state's readiness to respond to and recover from natural and man-made emergencies. During an emergency, the office functions as the Governor's immediate staff to coordinate the state's responsibilities under the Emergency Services Act. It also coordinates federal assistance for natural disaster grants. Since 2003-04, OES's Law Enforcement and Victim Services (LEVS) division has administered criminal justice grant programs formerly managed by the Office of Criminal Justice Planning (OCJP). Funding for the Office of Homeland Security (OHS) is also included in the OES budget.

The budget proposes to spend approximately \$1.1 billion in support of OES in 2006-07. Almost \$900 million of this amount is from federal funds, primarily local assistance funding for disaster assistance and homeland security grants.

*Preparing for Disasters and Homeland Security.* The administration has previously proposed the creation of OHS as a separate state entity. In anticipation of administration-sponsored legislation to establish OHS as an autonomous entity effective January 1, 2007, the OES budget includes only half-year support of OHS (\$170 million). The remaining half-year funding is shown in a new budget item (0685). We discuss this proposal and the administration's other disaster preparedness proposals in "Part V" of *The 2006-07 Budget: Perspectives and Issues*.

### **Department's Plan to Address Accounting Issues Pending**

*We withhold recommendation on the department's Law Enforcement and Victim Services division, pending review of a plan to address accounting concerns.*

*Accounting Problems Continue.* Beginning January 1, 2004, the department's LEVS division has been administering grants formerly

managed by OCJP. Due to weaknesses in OCJP's accounting records, OES encountered a number of serious problems. These problems included the inability to match expenditures with grant amounts and violations of federal grant management requirements. As a result, the federal government froze its grant monies for a time (two federal grants remain frozen). In addition, the Department of Finance's (DOF's) Office of State Audits and Evaluations completed an audit in February 2005 which attempted to reconstruct OCJP's accounting records. These problems have caused ongoing problems in OES' accounting efforts, particularly for the LEVS grants. The OES' problems have been exacerbated by vacancies in its budget and accounting units. For instance, the department reports that, for a short time, the budget unit was 100 percent vacant. Consequently, at the time this analysis was prepared, the department had been unable to close out its 2004-05 financial statements. The Governor's budget displays several appropriations that may have been over-obligated in 2004-05. Since it has been unable to finalize its financial statements, the exact amounts of any such over-obligations are still unknown.

***Department Developing Plan.*** In response to these problems, the department has taken a number of steps. For example, the department hired a consultant to provide short-term support and identify recommendations for improvement. The OES has also made efforts to fill its numerous vacancies. In addition, the department has been working with staff from DOF and the State Controller to close out its 2004-05 financial statements. The department has committed to developing a specific action plan to track necessary tasks, progress, and deadlines.

***Withhold Recommendation.*** We are encouraged that the department is taking its accounting problems seriously and is in the process of developing a detailed action plan to resolve them. To date, the magnitude of any appropriation over-obligations is still unknown. We withhold recommendation on the LEVS budget pending review of the action plan.

### **New Criminal Justice Grant Programs Not Justified**

***We recommend the deletion of (1) a \$6 million General Fund request for grants to enhance or establish local Sexual Assault Felony Enforcement teams and (2) a \$1.1 million request from the Victim-Witness Fund to extend victim-witness support services to parole revocation hearings. Neither proposal is well developed. (Reduce Item 0690-002-0001 by \$300,000, Item 0690-002-0425 by \$94,000, Item 0690-102-0001 by \$5.7 million, and Item 0690-102-0425 by \$1 million.)***

***Sexual Assault Felony Enforcement Teams.*** The Governor's budget proposes \$6 million in General Fund support for Sexual Assault Felony Enforcement (SAFE) teams. This includes \$5.7 mil-

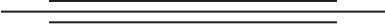
lion in local assistance, with the remainder used to support new OES staff to administer the program. Chapter 1090, Statutes of 2002 (AB 1858, Hollingsworth), authorizes these teams as partnerships between local, state, and federal law enforcement to (1) proactively monitor habitual sexual offenders and (2) collect data to determine if proactive law enforcement is effective in reducing violent sexual assault offenses. No state appropriation accompanied the bill. This proposal would provide General Fund support to enhance existing local and regional teams and to establish programs in counties where they do not already exist. Funding would be allocated to counties with 200 or more registered sex offenders (about 40 counties) based on each county's proportionate share of the offending population.

***Victim-Witness Services for Parole Revocation Hearings.*** The OES's LEVS division currently administers the Victim-Witness Assistance Program, which funds every county to operate comprehensive victim-witness assistance centers that provide support services to victims and witnesses during criminal proceedings. Victim advocates guide victims through the court process, help victims receive restitution, provide crisis intervention, and make referrals to counseling and community services. The administration proposes to establish a \$1 million grant program to assist counties in extending services to victims and witnesses that choose to participate in parole revocation hearings. The administration's stated objective is to increase victim-witness participation in such hearings, with the goal of sending more parolees back to state prison for crimes committed while on parole. Funding for this program would come from the Victim-Witness Fund, which is funded by criminal fines.

***Proposals Fail to Provide Important Details.*** For both proposals, the administration was unable to provide even the most basic information regarding the proposed grants. Regarding the SAFE teams, the administration was unable to provide information about how many such programs currently exist and how they are currently funded. In addition, Chapter 1090 specifically requires SAFE teams to collect data regarding their effectiveness. Yet, the administration could not provide any such data or analysis documenting the teams' level of success to date. The proposal also fails to demonstrate why state funding is necessary if the teams have been operating for the past several years without any state assistance. Similarly, the proposal to expand the witness assistance program fails to answer basic questions. The administration could not identify the current rate at which victims and witnesses attend parole revocation hearings or the extent to which the local assistance centers already provide these services. The proposal also does not identify the expected improvement in participation, how funding would be distributed, or the broader impact such participation is expected to have on criminal recidivism.

***Added Workload for Struggling Division.*** As noted above, the LEVS division is struggling to meet basic budgeting and accounting standards. The department asserts that adding two new grant programs would not further impair its progress in resolving these problems. Realistically, however, the financial problems will require ongoing attention by the department's executive management for the next several years. The department should be focused on meeting basic accounting and budgeting standards, rather than the development of new grant programs.

***Recommend Rejecting the Administration's Proposals.*** We recommend the Legislature reject the administration's proposals for SAFE teams and expanded witness assistance services as neither proposal is well developed.

## DEPARTMENT OF INSURANCE (0845)

The Insurance Commissioner is elected by voters and oversees the California Department of Insurance (CDI). The CDI regulates most of California's insurance market—the largest in the U.S. with over \$115 billion of direct premiums written annually. With nearly 1,300 employees, the department licenses and regulates over 1,500 companies and more than 340,000 agents and brokers. The commissioner has authority under law to review and approve certain aspects of insurance rates, address consumer complaints, ensure that insurance companies remain financially stable, and combat insurance fraud.

The budget proposes CDI expenditures of \$198 million in 2006-07. This is \$5 million, or 2.3 percent, less than authorized 2005-06 expenditures. Reductions in spending for one-time costs, consulting services, and grants to district attorneys account for most of the budgeted decrease in 2006-07. (The CDI also is requesting a reappropriation of \$1 million of unused 2004-05 funds to be awarded to district attorneys to combat health insurance fraud.)

The Insurance Fund, consisting of several accounts (some of which are restricted) that support CDI operations, derives revenues from regulatory assessments and fees. The department projects that the Insurance Fund's total fund balance will be \$29 million, or 16 percent of revenues, at the end of 2006-07.

### **Budget for Health Provider Complaint Unit Should Be Reduced**

*We recommend that the Legislature appropriate \$752,000 from the Insurance Fund and approve five new positions (a reduction of \$410,000 and five positions from the administration's request) to administer two new laws protecting health care providers and consumers. We also recommend that the Legislature adopt supplemental report language requiring the California Department of Insurance to report annually for the next three years on the workload resulting from the two new*

*laws so that lawmakers can consider whether more staffing should be authorized. (Reduce Item 0845-001-0217 by \$410,000.)*

**Background.** Under state law, the Department of Managed Health Care (DMHC) regulates health maintenance organizations and two preferred provider organizations (PPOs) that serve more than 80 percent of consumers in the market for health care coverage. The CDI regulates PPOs and indemnity insurance plans serving the rest of this market.

**New Laws.** The Legislature passed two laws in 2005 that resulted in the request for ten new staff positions. Chapter 723, Statutes of 2005 (SB 367, Speier), requires the commissioner by July 1, 2006 to establish procedures for receiving, processing, and addressing complaints concerning denied health care claims and related health insurance issues. The law's principal purpose is to give health providers the same rights to file complaints against CDI-regulated insurers that they already had for DMHC-regulated plans. Among the requirements of Chapter 723 are that the commissioner establish a Web page for receiving complaints and provide announcements informing consumers and providers that both this Web page and CDI's toll-free number now handle complaints concerning health insurers.

In addition, the Legislature passed Chapter 441, Statutes of 2005 (SB 634, Speier), which imposes requirements to limit unfair claims practices of CDI-regulated insurers. The requirements are similar to those already in place for DMHC-regulated plans. Chapter 441 requires insurers and agents to disclose certain information on claims practices and potential costs of services to providers and policyholders.

**Proposal.** In order to address the new requirements of Chapters 441 and 723, CDI requests \$1.2 million from the Insurance Fund and ten new positions (consisting of eight compliance officers and two staff counsel). Most of the staff members would work in CDI's consumer services and market conduct branch, which handles consumer inquiries and examines insurance company practices—such as claims handling—for various lines of insurance. The proposal also requests \$50,000 in ongoing spending authority to contract with a media firm to develop announcements concerning CDI's complaint Web page and toll-free telephone number.

**New Unit Should Be Smaller Than DMHC's.** Since the laws are new, it is unknown how many complaints CDI will receive. The DMHC regulates health organizations that serve more than four times as many Californians as those regulated by CDI. The DMHC's comparable provider complaint unit employs eight staff members. We would expect CDI to receive significantly less complaints than DMHC on an ongoing basis, although it may experience relatively more workload in the short term to deal with any built up backlog of complaints. Based on our review, we believe CDI can meet its new responsibilities under Chapters 441 and 723 with five new



positions (four insurance compliance officers and one staff counsel). This is a reduced amount from CDI's proposal but still provides proportionately more resources to CDI than DMHC (based on persons served). This recommendation would reduce CDI's request by \$410,000.

***Recommend Annual Reports on Workload of New Unit.*** Because the volume of complaints that will be generated by the new laws is unknown, we recommend that the Legislature require that CDI provide reports on its workload for at least the next three years. With this information, the Legislature and the administration will have a better idea of ongoing workload demands. The DMHC already produces extensive reports concerning the number, category, and status of complaints it receives. The CDI should produce reports similar in format to DMHC's, so that comparisons are possible. For these reasons, we recommend the adoption of the following supplemental report language:

Item 0845-001-0217—California Department of Insurance (CDI). The CDI shall submit calendar-year annual reports on or before July 1 2007, July 1, 2008, and July 1, 2009 to the Senate Health Committee, the Assembly Health Committee, and the Joint Legislative Budget Committee concerning the number, types, and status of health care provider, consumer, and other complaints processed each year under the provisions of Chapter 441, Statutes of 2005 (SB 634, Speier), and Chapter 723, Statutes of 2005 (SB 367, Speier). To the extent possible, CDI should provide this report in a format similar to that used by the Department of Managed Health Care in similar reports.

---

---

## CALIFORNIA GAMBLING CONTROL COMMISSION (0855)

Established by Chapter 867, Statutes of 1997 (SB 8, Lockyer), the California Gambling Control Commission is the primary public entity that regulates and licenses personnel and operations of the state's gambling industry. This industry has grown rapidly in recent years. The commission regulates 55 tribal casinos and more than 100 gambling establishments and cardrooms.

The 2006-07 Governor's Budget proposes a significant expansion of the commission's staff and mission. Specifically, the budget increases the size of the commission's staff to 72 positions, up 50 percent from currently authorized levels. Spending for commission operations would grow from \$8.4 million in 2005-06 to \$10.9 million in 2006-07, an increase of 31 percent. (The Governor's budget proposes a related expansion of the investigation activities of the Division of Gambling Control in the Department of Justice [DOJ]. We discuss that proposal in the "Judiciary and Criminal Justice" chapter of this publication.)

### EXPANSION OF COMMISSION STAFF JUSTIFIED, BUT PACE OF GROWTH AND FUNDING METHOD NEED CONSIDERATION

*We agree with the administration that the Legislature should expand the commission's staff. We, however, recommend rejecting the proposal to change existing policy and pay for some commission costs from the General Fund. Instead, commission operations should continue to be supported entirely by special funds with fees and charges for gambling-related activities. In addition, we recommend certain reductions in the administration's proposal. Specifically, we recommend: (1) rejecting the commission's request to expand its audit staff by six positions and (2) approving the three proposed positions for a new field inspection*

---

*program on a two-year limited-term basis. (Reduce Item 0855-001-0001 by \$725,000. Increase Item 0855-001-0367 by \$290,000.)*

## **Background**

***Gambling on Tribal Lands.*** As authorized by the federal Indian Gaming Regulatory Act, state law gives the Governor the power to negotiate tribal-state gambling compacts with federally recognized Indian tribes. The Legislature must approve all such compacts. Tribes agreeing to these compacts can operate slot machines, certain card games, and other types of gambling in California. Currently, 54 tribes operate around 55,000 slot machines. About one-half of these machines are in casinos in San Diego County and Riverside County. The number of casinos has increased 35 percent in the past five years, and the number of slot machines has increased 31 percent.

***1999 Compacts.*** Most tribes signed their current compacts in 1999, under which each tribe may operate up to two facilities with a total of 2,000 slot machines. In exchange, tribes make payments to two funds administered by the state, the Revenue Sharing Trust Fund (RSTF) and the Special Distribution Fund (SDF). The funds in the RSTF are distributed to tribes that do not operate slot machines or operate less than 350 machines. The SDF moneys are distributed in priority order to: (1) address shortfalls in the RSTF so that eligible tribes receive \$1.1 million annually, (2) fund programs addressing gambling addiction and related problems, (3) fund regulatory activities of the commission and DOJ, (4) provide grants for local government agencies affected by tribal casinos, and (5) achieve any other gambling-related purpose.

***2004 Compacts.*** In June 2004, five tribes signed amendments to their compacts, and these agreements were approved by the Legislature. Under the 2004 compacts, these five tribes may operate as many slot machines as they wish. In exchange, the tribes provide a combined \$100 million payment annually to the state, which is to be used to support an upcoming bond to repay a portion of the state's obligations to transportation funds. The tribes also provide additional payments to the General Fund for slot machines added to their facilities. In August 2004, two tribes signed new compacts, and two other tribes amended compacts, under which the tribes generally make payments to the General Fund based on the "net win" of their slot machines. Based on these nine 2004 compacts, tribes will pay a projected \$25 million to the General Fund in 2006-07.

***Compacts Will Result in Continued Gambling Expansion.*** Tribes with approved compacts now have about 25 new or expanded casinos under development. In addition, the Governor has reached agreement with

tribes on one amended and four new compacts, which await consideration by the Legislature.

## Proposal

The administration proposes to increase the commission's budget by \$2.5 million. (Special funds receiving gambling-related revenues would provide \$1.8 million of this amount, and the General Fund the balance of \$725,000.) The proposal requests 24 new positions and the conversion of 2.5 limited-term licensing staff positions to permanent ones. Specifically, the commission requests the following increases in staffing:

- 5.5 positions to expand its licensing division, which currently has 7.5 authorized positions. In addition, 2.5 limited-term licensing program positions would be converted to permanent positions.
- 6 auditors and support staff, to expand a current staff of 9 auditors.
- 3 analysts and technicians for a new field inspection program, principally to inspect gaming devices quarterly under terms of the 2004 compacts.
- 5 engineer and technician positions (on a two-year limited-term basis) for a new technical services, research, and testing program for gambling machines.
- 4.5 administrative, information technology, and legal positions based on workload needs.

*Comparison to 2005-06 Proposal.* The 2005-06 Governor's Budget requested an augmentation of \$4.8 million and 46 new positions for the commission. This proposal was rejected by the Legislature. The 2006-07 proposal—while similar in some respects—provides less funding for expansion. In general, the 2006-07 proposal is much better justified than the plan offered one year ago. For instance, the 2005-06 expansion proposal requested funds to hire 13 new staff for field inspections and a new state gambling testing laboratory. The 2006-07 proposal also creates a field inspections unit, but the testing laboratory has been replaced with a proposal for a better defined technical services, research, and testing program to assist in regulating increasingly complex electronic gambling devices. In addition, the 2006-07 proposal—unlike the plan of one year ago—is coordinated with a \$3.3 million proposal by DOJ to expand its Division of Gambling Control.

## **No Need for General Fund Dollars**

The commission currently receives all operational funding from the SDF and the Gambling Control Fund (for cardroom regulation), which receive gambling-related fees and revenues. The administration proposes to fund part of the costs of the commission's expansion (as well as that of DOJ's investigative activities) from the General Fund. The administration's rationale is that, since some tribes make payments to the General Fund, a proportion of regulatory costs should also be paid from the General Fund. As noted above, however, state law and the compacts allow commission regulatory funding to come from SDF. (The SDF is projected to have a fund balance of \$113 million at the end of 2006-07). We therefore recommend continuing to fund commission regulatory activities exclusively from revenues derived from the industry itself, as is usually the case with other regulatory agencies. Shifting costs from the General Fund to the SDF results in a General Fund benefit of \$725,000.

## **Increased Workload and Technology Justify Expansion**

*Tribal and Other Gambling Activities Have Increased Workload.* The commission provided information that shows its workload has increased substantially with recent expansions of gambling in the state. The number of applications it considered for the licensing of owners, employees, and other professionals, for example, more than quadrupled between 2002-03 and 2004-05. The 2004 compacts established new commission duties (generally not implemented to date) with respect to audits and quarterly inspection of casino devices. New regulations require manufacturers and distributors of gambling equipment to provide specific information each quarter on shipments within the state. The commission also now regulates "proposition player" companies, which provide hired players to start games or keep games going at casinos, thereby attracting other patrons to the gambling table.

## **Commission Needs to Improve Productivity, Prove Worth of New Units**

While we agree with the administration that the Legislature should expand the commission's staff, we have concerns with components of the administration's proposal, which are discussed below.

*Recommend Rejecting Proposed Audit Staff Expansion.* The commission reports that it has completed only about six full audits of tribes since its inception, citing several provisions of the state's compacts that restrict its ability to audit tribal operations effectively. Expanded workloads and turnover also seem to be responsible for some of the poor record to date.

Until the commission can provide evidence of improving productivity of existing staff, expansion is not warranted. We recommend, therefore, that the Legislature reject the proposal to expand the auditing staff at this time. This change would reduce the total costs of the expansion proposal by approximately \$435,000.

***Recommend Making Inspection Positions Limited-Term.*** The Governor's budget for 2006-07 requests eight positions for two proposed new units: (1) a three-member field inspection unit principally for inspecting casinos quarterly under the 2004 compacts and (2) a five-member technical services, research, and testing unit to assist commissioners and staff (including field inspectors) with technical issues associated with the functioning, integrity, and operations of today's advanced gambling equipment. Other states with significant concentrations of casinos, such as Nevada and New Jersey, already have regulatory units of this type. But, with no track record in this area, the commission needs to show that these new units produce more benefit for the state, gambling partons, and tribes than they cost. Consequently, we recommend that the new positions in the inspections unit—like those proposed for the new technical resources unit—be approved on a two-year limited-term basis.

---

---

## BOARD OF EQUALIZATION (0860)

The Board of Equalization (BOE) is one of California's two major tax collection and administration agencies. In terms of its responsibilities, BOE: (1) collects state and local sales and use taxes (SUT) and a variety of business and excise taxes and fees, including those levied on gasoline, diesel fuel, cigarettes, and hazardous waste; (2) is responsible for allocating certain tax proceeds to local jurisdictions; (3) oversees the administration of the property tax by county assessors; and (4) assesses certain utilities and railroad property. The board is also the final administrative appellate body for personal income and corporation taxes, which the Franchise Tax Board (FTB) administers. The BOE is governed by a constitutionally established board—consisting of four members elected by district and the State Controller.

The 2006-07 Governor's Budget proposes \$371 million in support of BOE operations, of which \$213 million is from the General Fund with most of the remainder consisting of reimbursements from local governments. The proposed level of support represents an overall decrease in funding of \$8 million from the 2005-06 level and a net decrease of \$10 million from the General Fund. The number of personnel years for the BOE is budgeted to increase slightly from 3,795 to 3,803.

### ALLOCATION OF SALES AND USE TAX ADMINISTRATIVE COSTS

*We recommend the enactment of legislation implementing a new simplified methodology for allocating administrative costs associated with the sales and use tax (SUT) on behalf of various taxing entities. We further recommend that the Legislature consider statutory changes that would allow for allocating administrative costs to all tax programs within the SUT. (Reduce Item 0860-001-0001 by \$6 million and increase reimbursements by an identical amount.)*

## State and Local Sales and Use Taxes

*Sales and Use Tax Background.* The sales and use tax (SUT) is levied by a number of different entities in the state. The basic state-wide rate is 7.25 percent consisting of: 5 percent General Fund, 0.5 percent Local Revenue Fund, 0.5 percent Local Public Safety Fund, and 1.25 percent uniform local rate (known as the Bradley Burns tax). In addition, in some geographic areas, optional rates approved by local voters are levied by special taxing jurisdictions (STJs). (See *P&I*, Part II, “Perspectives on State Revenues” for additional background information about the SUT.)

The BOE administers the SUT at a cost of almost \$300 million annually and allocates its costs among the state General Fund and special funds, and all uniform and STJ funds. The administrative process encompasses (1) registration of taxpayers, (2) processing of tax returns and payments, (3) auditing of taxpayers, and (4) collection of delinquent taxes. Under current law, the BOE allocates its administrative costs among most of the tax components. The BOE allocates costs among the General Fund, the local uniform tax, and the STJs; however, no administrative costs are currently allocated to the Local Revenue Fund or the Local Public Safety Fund.

*Special Taxing Jurisdictions Are Growing in Importance.* Under current law, voters within local government jurisdictions—cities, counties and special districts—can approve special SUT rates that are imposed as an additional tax within the boundaries of a specific geographic area or STJ. The first such special tax rate was imposed by voters in the San Francisco Bay Area in 1970 as a means of providing funding support for the Bay Area Rapid Transit District.

Since that time, the number of STJs has grown rapidly, with 64 jurisdictions now levying an additional tax. In addition, a number of STJs are expected to come on line in the future. For example, there will be a net increase of six STJs beginning on July 1, 2006, and more are being considered for inclusion on the June 2006 and November 2006 ballots. The additional taxes levied by the STJs range from 1 percent by the City of Trinidad in Humboldt County to 0.1 percent for the Fresno Country Zoo Authority. However, most STJs add a rate of 0.5 percent to the existing statewide uniform rate of 7.25 percent. Under agreements made with each of the STJs, the BOE is responsible for administering the application and collection of the tax in each of the special jurisdictions.

## Allocation of Administrative Costs

*Current Cost Allocation.* The BOE charges the General Fund, local governments, and local jurisdictions a fee for administering the local tax programs on their behalf based on current law. Current law requires the use of a “cost-allocation model” that is based on recommendations made in



1992 and 1996 reports by the Office of the Auditor General (now the Bureau of State Audits). In general, these recommendations centered on attributing costs associated with administering the taxes to the actual workload that such taxes impose on the agency. In addition, Chapter 865, Statutes of 1998 (AB 836, Sweeny) and Chapter 865, Statutes of 1999 (SB 1302, Senate Committee on Revenue and Taxation), required that such administrative fees be capped at a specified proportion of revenues.

***Current Costing Model Is Complex.*** In an effort to comply with various statutory requirements, the BOE's costing model has become increasingly complex and expensive to administer. As new STJs have been established, adjusting the model has become an expensive and resource-intensive undertaking. Gathering the data necessary to calculate workload requirements is now a sizeable task, while the data gathered through such efforts (including number of seller permits, number of returns, and hours worked) often are not particularly reflective of the actual workload involved. (Workload is difficult to quantify because the existing time reporting system does not track costs to the necessary level of detail.) As a result of the cap mechanism referred to above, the General Fund subsidizes certain STJs for administrative costs; for these STJs the link to actual costs is even more tenuous.

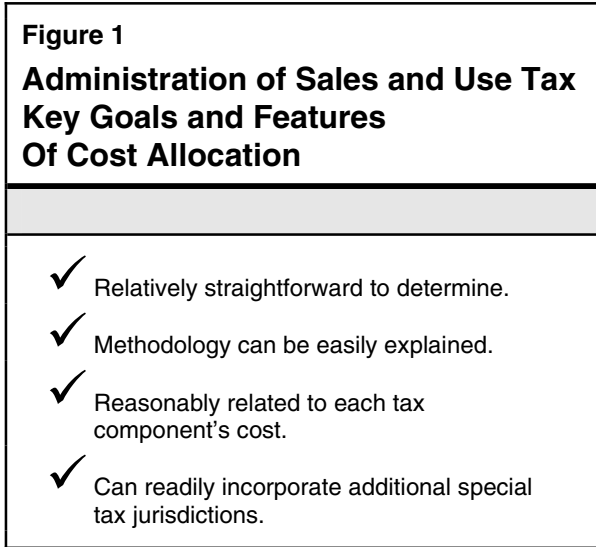
The complexity of the costing model has made its results increasingly difficult to explain to local agencies. This is especially true in situations where fees may increase as a result of workload changes, yet revenues to the particular STJ are actually decreasing. In fact, the ratio of administrative costs to revenue can vary widely depending upon circumstances. In addition, it is difficult to estimate with any precision the likely fees for new STJs that come on line.

***Alternative Fee Structures.*** As part of the 2004-05 Budget Act, the Legislature required that BOE report by December 1, 2004 regarding alternative methodologies by which to allocate administrative costs associated with the state and local SUT. In consultation with the Department of Finance, STJ representatives, and the Legislative Analyst's Office (LAO), the BOE developed several alternatives that attempted to address the overall goals and features shown in Figure 1 (see next page).

Of the alternatives developed by BOE, we believe its "modified revenue" model best meets the criteria listed in Figure 1. Basically, the model identifies four key types of workload, and uses—for three of the workloads—revenue-related "proxies" as a way of allocating costs to the different funds/jurisdictions. The workloads and cost allocation methods are:

- ***Registration.*** Allocated based on total revenue actually received through the normal returns process.

- **Return Processing.** Allocated based on the number of return lines used in the filed tax returns.
- **Audits.** Allocated based on the tax change associated with audits of each of the taxes.
- **Collections.** Allocated based on revenue collected for the benefit of each of the SUT funding sources.



The approach described above would eliminate the current somewhat arbitrary cap on administrative costs as a percent of revenue. Additionally, it would ease the cost of administration for BOE and provide a much more transparent process for other taxing entities. Finally, the methodology proposed could easily incorporate additional STJs as they are approved by voters, and accommodate adjustments to the rate or base of existing tax components.

The modified revenue model for allocating costs would have differential effects on individual components of the SUT—including the state General Fund, uniform local taxes, and special taxes. In addition, substantial shifts might occur within the uniform local revenue components and the STJ component. Any shift in the existing distribution of costs is likely to bring objections from those who would end up paying more and support from those who would pay less. Nevertheless, we think that the proposed alternative is a more reasonable method through which to allocate costs than that currently used.

**Local Revenue Components Not Assessed for Costs.** The BOE does not believe that it has the authority under current law to assess either the Local Revenue Fund or the Local Public Safety Fund for a share of SUT-related administrative costs. As a result, the apportioned costs associated with these two funds are shared by the General Fund and the local entities.

## LAO Recommendations

In view of the issues associated with the current costing methodology, we recommend the enactment of legislation implementing a simplified methodology that will nevertheless reasonably approximate the workload associated with each of the SUT's major funding sources. Under the modified revenue proposal described above, the share borne by the state General Fund and the STJs would drop slightly, while the share borne by the uniform local tax would increase somewhat. These changes are shown in Figure 2. The reduction in the proportion of costs borne by the General Fund (from 72 percent to 70 percent) would translate to a General Fund savings of \$6 million.

<b>Figure 2</b>				
<b>Sales and Use Tax Cost Allocation</b>				
<i>(Percent of Total Costs)</i>				
	<b>State</b>		<b>Local</b>	
	<b>General Fund</b>	<b>Special Funds</b>	<b>Uniform</b>	<b>STJs<sup>a</sup></b>
Current	72%	—	13%	15%
Proposed	70	—	17	13

<sup>a</sup> Special taxing jurisdictions.

We further recommend that the Legislature consider legislation allowing for the assessment of administrative costs that are attributable to administering the Local Revenue Fund and the Local Public Safety Fund. Enactment of this recommendation would result in additional General Fund savings of \$30 million.

## SALES AND USE TAX GAP

*To date, the Board of Equalization's efforts in closing the tax gap in sales and use taxes have been limited. We recommend that the department provide information at budget hearings regarding additional proposals for curtailing tax noncompliance.*

### What Is the Tax Gap?

At both the state and federal levels, much concern has been raised regarding the “tax gap”—that is, the difference between what is legally owed by taxpayers and what is actually remitted to the government. The tax gap has long been in evidence, but officials are concerned that not only is the tax gap persisting, but it also is growing in size relative to the underlying tax base. The tax gap is further examined in our report entitled, *California's Tax Gap* (February 2005). The Legislature expressed its concern in the *2005-06 Budget Act* regarding this issue by requiring the BOE to prepare a report about the SUT gap.

### How Big Is the Tax Gap?

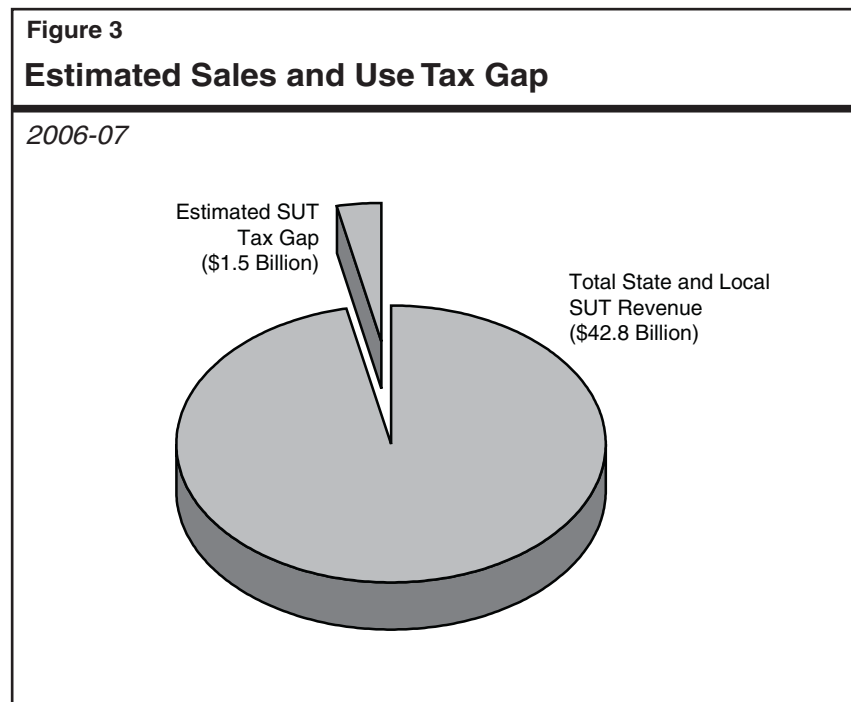
Estimating the size of the tax gap is, by its very nature, a difficult exercise. However, through various indirect means federal and state officials have managed to estimate the gap's overall level of magnitude. At the federal level, the tax gap associated with income taxes is over \$300 billion. For California, the nonpayment of personal income taxes (PIT) and corporation taxes (CT) is estimated to be \$6.5 billion, or about 8 percent of General Fund revenues. Regarding SUT, studies by other states and multistate organizations suggest that California's tax gap for this tax is between \$1 billion and \$3 billion. As shown in Figure 3, BOE estimates the gap to be about \$1.5 billion, equal to 3.5 percent of total state and local revenues raised by the tax.

### Components of the Sales and Use Tax Gap

Much less is known regarding the characteristics of the SUT gap, than those of the PIT or the CT gaps. This is due largely to the fact that there is significantly more documentation filed by taxpayers and independent third parties as part of administering the income tax programs.

The SUT has both a *sales* tax component (collected by sellers of consumed items sold in the state) and a *use* tax component (levied on goods purchased outside of the state but consumed in California). To the extent that sales tax noncompliance occurs, this typically relates to understatements regarding the amount of taxable sales actually made. For example, a

seller may not obtain the required seller's permit or simply not file a sales tax return as required. In other cases, a seller may understate actual sales made through a cash transaction. In still other situations, a business may obtain a fraudulent reseller's certificate and purchase items for its own use on a tax-free basis.



The majority of SUT gap, however, is attributable to the use tax component (as opposed to the sales tax component). The use tax is required to be remitted by individuals and businesses that have purchased items outside of the state, but are consumed in California. The three main areas of use tax noncompliance are:

- **Use Tax Remittance by California Business Consumers.** Business purchasers of equipment and supplies are required to pay sales tax on in-state purchases and use tax on out-of-state purchases (if the items are not for resale). The lack of payment of the use tax can often occur due to ignorance of the tax law, a misunderstanding of the obligations to remit such a tax, or intentional noncompliance. This type of noncompliance occurs most frequently among businesses that are not registered sellers in California, such as legal, health, and business services.

- **Use Tax Remittance by California Household Consumers.** This area represents another large component of the use tax gap. Non-compliance in this area is due to ignorance of the requirement to remit the use tax associated with out-of-state purchases (including Internet or catalog sales), and to the difficulty of collecting the tax without creating onerous compliance burdens.
- **Use Tax Collection by Non-California Sellers.** The final main area of use tax noncompliance relates to certain businesses located outside of California. Their obligation to collect the use tax is based on the state's determination that they have nexus—or presence—with California. Determination of nexus could be based on one of several factors, including (1) a warehouse in California, (2) employees based in California, or (3) an agent based in California. Noncompliance by these businesses may be due to a lack of awareness of the requirements of the law, a misapplication of the law, or an outright flouting of the tax law in order to lower consumer prices and thereby increase sales.

### **Bridging the Tax Gap**

**Existing Programs Are in Place.** The BOE has initiated a number of programs designed to curtail specific activities that contribute to the tax gap. For example, the BOE conducts what it calls the "Form 1032 Nexus Program," which provides leads (through audits of California businesses) on out-of-state businesses that should be collecting the state's SUT due to their nexus with California. The BOE reports that this program is successful, raising about \$6.5 million in 2004-05 on costs of about \$0.5 million annually with a similar return expected in 2005-06.

In addition, through the state's participation in the Multistate Tax Commission, it receives referrals regarding businesses that may have nexus with more than one state. The BOE can then pursue these leads to determine whether these companies are collecting the SUT on behalf of California. The BOE reports that this program is only marginally successful in generating revenues. Other efforts by BOE to date are limited and are likewise only marginally successful in increasing tax compliance.

At the direction of the Legislature, BOE prepared a report regarding the SUT tax gap. The report was to identify specific strategies and steps for reducing the tax gap, estimate revenues that would be produced by these strategies, the cost of implementing each approach, and recommend those actions that the board determined would be most cost-effective and feasible. The BOE identified three potential programs that would together generate annual revenues of about \$50 million. In addition to the items

addressed in the report, the BOE will report in its 2006-07 budget hearings on the findings of its pilot audit of the use of resale certificates.

***Additional Programs Are Proposed.*** As part of the 2006-07 Governor's Budget, additional measures are proposed to address the SUT tax gap. These programs were identified in BOE's report discussed above. Specifically, the administration proposes the following tax gap programs:

- ***Retail Licensing Enforcement.*** This proposal targets businesses engaged in selling taxable items in California which do not have a seller's permit and thus do not file tax returns with the BOE. (The BOE indicates that this component is the largest sales tax-related part of the SUT tax gap and accounts for uncollected revenues of \$300 million annually.) The proposal would fund 14.5 two-year limited-term positions at a cost of \$1.6 million (\$1 million General Fund) in 2006-07, with a somewhat lower funding requirement (\$1.5 million) for the second year. By identifying and registering entities which actively engage in business in California, the program will raise an estimated \$12.6 million annually.
- ***Agricultural Inspection Station Tax Leads.*** This proposal targets property being transported into California without payment of the use tax component of the California SUT. The proposal would fund 16 two-year limited-term positions at a cost of \$1.4 million (\$800,000 General Fund) each in 2006-07 and 2007-08. Under an interagency agreement between BOE and the California Department of Food and Agriculture (CDFA), CDFA would collect documentation (for example, bills of lading) on behalf of BOE. Such documentation would provide the BOE with evidence regarding the associated business's compliance with registration, filing, and tax remittance requirements. The program is estimated to generate \$9 million in the first full year of operation.

***But Should More Be Done?*** The BOE's and administration's tax gap-related efforts represent reasonable policy initiatives. However, the proposals put forth by the administration, while commendable—represent piecemeal approaches to specific tax gap-related activities. Additional proposals were approved by BOE but were not chosen for funding by the administration. One of these activities—so-called “discovery audits”—is an important component of an effective audit program and an effective means of addressing the tax gap through systematic changes in tax administration. Improving audit selection—through discovery audits or other improvements in audit selection methods—represent more fundamental approaches to dealing with noncompliance.

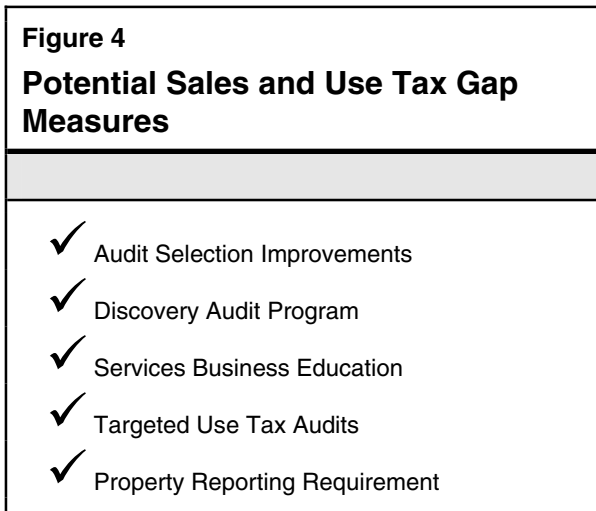
The FTB—the state's tax agency responsible for administering income taxes—has long devoted resources to discovery audits, the objective of

which is to get a better sense of potential and emerging areas of tax non-compliance. Unlike other states with large SUT programs, however, BOE devotes few resources to audit selection to help determine the highest return audits. In contrast, Arizona, with a substantially smaller population, has in the past delegated five staff specifically to audit selection.

We would also note that the BOE has identified use tax noncompliance by service industry businesses as a major contributor to the tax gap. For example, many professional offices and consulting firms use equipment and furniture purchased from out of state, but fail to pay the use tax owed to California on such items. As we indicated earlier, this may be due to either inadvertent or willful actions on the part of businesses. Despite the importance of this sector as a contributor to the tax gap, neither the BOE nor the administration has put forth a proposal to address it.

### LAO Recommendations

We recommend that the BOE report to the Legislature at budget hearings regarding potential additional tax gap programs, as shown in Figure 4. Specifically, BOE should identify policy issues along with an estimate of administrative costs and additional revenues for the following initiatives:



- **Audit Selection Improvements.** Reallocate existing resources to improve audit selection methodology.



- **Discovery Audit Program.** Initiate discovery audit program for the SUT in order to improve audit selection.
- **Services Business Education.** Design education program for certain service businesses regarding their use tax obligations.
- **Targeted Use Tax Audits.** Establish pilot program of targeted audits for selected service industries regarding use tax compliance.
- **Business Personal Property Reporting Requirement.** Expand the form and require businesses to file personal property forms with county assessors and BOE.

## ELECTRONIC TECHNOLOGY PLANNING

*We recommend that the Board of Equalization report at budget hearings regarding the status of efforts to convert existing registration, tax filings, and manual processing to electronic systems, including the agency's medium- to long-term goals regarding this technology, together with estimates of related savings and costs.*

The application of electronic technologies to tax administration has expanded rapidly over the last decade. As we indicated in our January 2005 report, *Tax Agency Consolidation: Remittance and Return Processing*, the Employment Development Department (EDD) and FTB have increasingly converted to electronic technologies in the filing of tax returns and remittances as well as the processing of this documentation.

The advantages of shifting to electronic remittances and returns are significant. From the taxpayers' perspectives, using electronic filing can minimize record keeping requirements, increase filing accuracy, and reduce costs in the long term. From tax agencies' perspectives, electronic technologies decrease processing time, reduce storage costs, minimize personnel requirements, improve data accuracy, and facilitate sharing of information for enforcement and compliance purposes.

**Processing Costs Are Lower for Electronic Processing.** The processing costs associated with electronic registration, returns, and remittances are far below those for paper documentation. For example, FTB estimates that 4,800 electronic remittances can be processed for each direct staff hour. For paper submissions, only 65 remittances can be processed for each direct staff hour. At EDD, just over 40 percent of the volume of remittances is by paper, but these remittances consume 80 percent of related staff time. Similarly, paper tax filings represent 50 percent of the total, but use 85 percent of processing-related resources. Additional savings typically

occur because the electronic submissions of remittances and returns are more accurate than their paper counterparts.

*Work on Electronic Technologies Should Continue.* Although BOE has made some efforts in the electronic technologies and automation area, there are still substantial additional improvements that could be made. For instance, while the agency receives about 60 percent of total SUT payments through electronic funds transfer, electronic tax filings represent only a small share of total tax returns. The BOE implemented electronic filing for single-location taxpayers in September 2005. It plans to extend the e-filing technology to businesses with multiple locations in the future. In addition, in its report to the Legislature, "Field Office Operations," the agency indicated that it is developing additional electronic interfaces through the Internet, including registration; petitions; and claims for refund, account balances, and account maintenance.

Our largest concerns with BOE's plans center on the length of time that is projected for the various components to come "on line." For example, extending e-filing to businesses with multiple locations is not expected until 2008. The additional components discussed above as part of field office operations are not planned for implementation until well after that date.

Investing in electronic technologies is likely to have substantial payoff over the medium- to long-term in terms of budgetary savings, due largely to reduced staffing requirements as well as the number of required field offices. In addition, the technology is likely to have significant benefits for coordination and information sharing among the tax agencies for enforcement and compliance purposes. Finally, a shift to electronic filing will simplify filing requirements and result in reduced costs for taxpayers.

While converting to electronic filing and processing would result in annual savings for the state in the medium- to long-term, it is also important to note that investing in electronic technologies would likely require up-front investment. Given the complexity of the issues associated with electronic filing and processing—as well as the budgetary impact—we recommend that BOE report at budget hearings regarding its near- and medium-term goals regarding this technology, including estimates of related savings and costs.

---

---

## SECRETARY OF STATE (0890)

The Secretary of State (SOS), a constitutionally established office, has statutory responsibility for managing the filing of financial statements and corporate-related documents for the public record. The SOS, as the chief elections officer, also administers and enforces election law and campaign disclosure requirements. In addition, SOS appoints notaries public, registers auctioneers, and manages the state's archives.

The budget proposes total expenditures of \$77 million for the SOS in 2006-07. The two primary ongoing sources of funding are the General Fund (\$32 million) and the Business Fees Fund (\$34 million). In addition, the current-year budget estimates expenditures of over \$253 million in federal funds for the implementation of the Help America Vote Act of 2002 (HAVA). We discuss the implementation of HAVA below.

**Special Election Costs.** The Governor proposes to augment the current-year budget for SOS by an additional \$54 million for the costs of the special election. The administration intends to seek legislation to appropriate these funds. Of this amount, \$9 million is for state costs—such as the printing and mailing of voter information guides. Without these additional funds, SOS would have no budgeted funds for these activities related to the June 2006 primary election. The remaining \$45 million is to reimburse counties for their election costs such as the printing and mailing of sample ballots, operating polling places, and counting ballots. Under current law, the state is not obligated to reimburse counties for these costs.

## HAVA BACKGROUND

### Federal Election Reform

In October 2002, Congress passed and the President signed HAVA. As the state's chief elections officer, SOS is charged with administering the

state's compliance with HAVA. Recent federal budgets have provided California with more than \$350 million to implement HAVA requirements.

## HAVA Requirements

The HAVA contains a number of specific requirements for states and counties related to election procedures. Among the requirements of HAVA are:

- **Replacement of Punch-Card Machines.** Counties must replace their punch-card voting machines in favor of more modern technology in time for the June 2006 primary election.
- **Statewide Voter Registration Database.** The state was required to have in place by January 1, 2006 a computerized statewide database of voter registrations. Each voter must have a unique identification number. The database must be accessible to county election officials. In addition, the database must coordinate with three state agencies—the Department of Motor Vehicles (registrations from drivers' license applications), the Department of Health Services (death records), and the Department of Corrections and Rehabilitation (felons' voting status).
- **Disabled Access.** All precincts must have at least one voting machine that is accessible to the disabled beginning with the June 2006 primary election.
- **Voter Identification.** Beginning in 2004, first-time voters who register by mail have to provide identification at some point in the voting process (either when registering or voting).
- **Other Requirements.** The HAVA also imposed new requirements relating to the handling of voters whose eligibility cannot immediately be determined (provisional ballots), voting by members of the military and overseas citizens, the handling of complaints, and the education of voters and poll workers. Generally, these requirements came into effect in 2004.

## FEDERAL FUNDING FOR HAVA

### California's Share of Funding

To help states implement the HAVA requirements, the federal government has allocated states about \$3 billion in funds. Of this amount, California has received more than \$350 million. Figure 1 summarizes the state's spending of HAVA funds.

**Figure 1**  
**Spending of California's HAVA Funds**

(In Millions)

Category	Spending			Total Funding
	Prior to 2004-05	2004-05	2005-06 And Later <sup>a</sup>	
Replacement of county voting machines	\$51.1	\$3.8	\$2.4	\$57.3
Disabled access	—	—	3.3	3.3
SOS administration	1.4	1.3	1.7	4.4
Other HAVA activities	4.0	10.0	273.2	287.2
Interest earnings	—	—	6.7	6.7
<b>Totals</b>	<b>\$56.5</b>	<b>\$15.1</b>	<b>\$287.3</b>	<b>\$358.9</b>

<sup>a</sup> Includes funds budgeted for 2005-06 and proposed spending for future years.

### Spending Options

In two cases, the federal government has provided funding for specific activities—the replacement of voting machines and disabled access. For the vast majority of the funds, however, the federal law does not mandate how much money should go to implementing each particular HAVA requirement. Rather, each state is responsible for meeting all of the requirements of federal law and may choose how to allocate the funds. While some of HAVA's requirements are fairly specific, others are much broader. For instance, the law's requirement to educate voters on election procedures could be implemented in a wide range of ways—from providing additional information in the state voters' guide to conducting a statewide media campaign. Consequently, the state has a great deal of discretion in allocating the federal funds.

Federal law generally does not place restrictions on the state as to when the HAVA funds must be spent, although the law is focused on the implementation of requirements in time for elections in 2006 or earlier. Unlike most federal programs, the state is able to keep any interest earned while the HAVA funds are in state accounts. This interest must be spent on HAVA-related activities. The SOS currently estimates that roughly \$6.7 million in interest has been earned to date.

## STATUS OF HAVA SPENDING

Below, we describe the state's HAVA spending plan, which allocates the federal funds to various purposes. Then, we detail the current status of spending—both for nondiscretionary and discretionary purposes.

### Development of a State Spending Plan

*Piecemeal Spending.* From the time of HAVA's passage until the spring of 2005, California's HAVA implementation operated on a piecemeal spending basis, without the approval of a comprehensive spending plan. From 2002-03 through 2004-05, a total of \$71.6 million of HAVA funds were spent, primarily for the replacement of county voting machines. The remaining \$16.7 million was spent on:

- *State Operations.* A total of \$6.7 million was spent by SOS on consulting services, employee salaries, the printing and mailing of permanent absentee voter materials, and other administrative expenses.
- *November 2004 Election.* An additional \$10 million was spent on activities related to the November 2004 election. The vast majority of these funds (\$9.7 million) were provided to counties for voter education, poll worker training, and improved security measures.

*March 2005 Spending Plan.* The 2004-05 Budget Act required that SOS develop a comprehensive approach to HAVA spending with detailed information on each component of spending. In March 2005, a spending plan was submitted by SOS and approved by the Department of Finance (DOF). The plan was endorsed by Secretary McPherson in April 2005 after he assumed his new position as Secretary. In January 2006, the SOS proposed amendments to this plan. At the time this analysis was prepared, the amendments were pending before the Legislature (through a 30-day notification process). The proposed spending plan would leave about \$10 million in unallocated funds. Figure 2 summarizes the proposed spending.

### Status of Nondiscretionary Spending

#### Replacement of County Voting Machines

Regarding the funds allocated to the replacement of county voting machines, federal law specifies how the funds are to be distributed. Each precinct, which used a punch-card voting system in the November 2000 election, is eligible for an equal allocation of the state's \$57 million. Almost

18,000 California precincts in 30 counties meet this criteria—resulting in an allocation of about \$3,200 per precinct. Thus far, all but two of the counties have completed their applications. Under federal law, all counties must replace their punch-card voting machines in time for the June 2006 election.

<b>Figure 2</b>		
<b>Proposed HAVA Spending Plan— January 2006</b>		
<i>(In Millions)</i>		
	<b>2005-06</b>	<b>2006-07</b>
<b>Nondiscretionary Funds</b>		
Replacement of county voting machines	\$2.4	—
Disabled access	3.3 <sup>a</sup>	—
<b>Payments to Counties</b>		
Voting equipment grants	\$195.0	—
Training grants	4.5	\$5.0
<b>Other Activities</b>		
Administration	\$1.7	\$1.7 <sup>a</sup>
Statewide database		
Interim solution	3.5 <sup>a</sup>	—
New system	1.6	52.9 <sup>a</sup>
Audits	1.5	—
Source code review	1.2 <sup>b</sup>	—
Registration cards	1.1	—
Voter education	0.7	0.4
Voting system reviews	0.3	—
Poll monitoring	0.1	—
<b>Totals</b>	<b>\$216.9</b>	<b>\$60.1</b>
Unallocated Reserve		\$10.3
<sup>a</sup> Legislative review of these proposals was pending at the time this analysis was prepared.		
<sup>b</sup> Spending not yet authorized by the Department of Finance.		
Note: Totals may not add due to rounding.		

## Disabled Access

Originally, \$2.4 million was allocated for grants to improve election accessibility and participation by disabled voters. Since that time, the state has received an additional \$0.9 million in federal funding for these types of

grants. The SOS has allocated the \$3.3 million to all counties based on the Proposition 41 voting modernization bond formula (which is weighted by number of voters and polling places). The grants will be used to improve physical accessibility at polling places and increase training and education regarding rights and procedures for disabled voters. To date, 38 counties have signed a contract with SOS and received their allocations.

## **Status of Discretionary Spending**

### **Payments to Counties**

*County Voting Equipment Grants.* Under the spending plan, \$195 million in HAVA funds is allocated to counties for the purchase of voting equipment and related costs. These funds can be used to supplement other funds (nondiscretionary HAVA and Proposition 41 allocations) to upgrade voting equipment or to purchase machines that are accessible to the disabled. The funds are to be allocated in the same manner as the disabled access grants, using the Proposition 41 bond formula. The SOS reports that it recently finalized a contract for these grants and counties are beginning to apply for the funds.

*County Training Grants.* In addition, the spending plan allocates nearly \$10 million over two years for grants to counties for broader purposes. These smaller grants are intended to educate voters and train poll workers and election officials on new HAVA procedures. The SOS, however, reports that no progress has been made this fiscal year in distributing these funds and its future plans regarding the grants are unknown.

### **SOS Administration**

Since 2003-04, SOS has received \$1.7 million annually to cover state staff and other administrative expenses. (In past years, a portion of the funds have been unspent and become available for other HAVA purposes.) In 2005-06, the two largest budgeted items in this category were for state staff (\$518,000) and a consulting contract with MGT of America to provide assistance to SOS in managing the HAVA program (\$400,000). The SOS reports that the contract with MGT was terminated in September 2005 so that SOS staff, rather than the consultants, could perform more day-to-day activities.

### **Statewide Database**

As noted above, one of the major HAVA requirements is that states have a computerized voter registration database in place by January 1, 2006. The SOS has pursued a two-fold strategy to meet this requirement.



First, the department is making upgrades to the existing CalVoter system. Concurrently, the department is pursuing the development of a new system, called VoteCal. On November 2, 2005, SOS and the U.S. Department of Justice (U.S. DOJ) signed a Memorandum of Agreement formalizing this approach. The agreement lays out the steps that the SOS will take on both of these projects. In exchange, the U.S. DOJ agreed not to pursue legal action against the state for noncompliance with the HAVA database requirement while VoteCal is under development.

**Interim Solution.** The existing CalVoter system is county-based, with information primarily entered and stored at the county level. The state has implemented a number of new components to CalVoter in recent months. Among the steps taken to improve the existing system are developing data exchange standards and requiring timely data updates from counties. In addition, the system has been upgraded to meet specific HAVA requirements—such as developing a unique identifying number for each voter and communicating with other state departments regarding drivers' licenses, death records, and felony convictions. In the opinion of SOS and U.S. DOJ, these improvements are only a stopgap approach until a new system is developed. In their view, the county-based approach of CalVoter inherently limits the state from validating the accuracy of updates. The interim solution has incurred costs of \$2.8 million to date.

**New System.** The SOS submitted a feasibility study report (FSR) to DOF to develop the new VoteCal system. The DOF approved the FSR in January 2006. Although the spending plan initially allocated \$47 million for the database project, the FSR estimates spending more than \$73 million to develop and operate the system over six years. The SOS proposes to spend \$57 million of this amount from HAVA funds, with the remainder coming from the General Fund. The SOS envisions VoteCal as a state-based database, with the information stored at the state level. The plan is to have most counties integrate their existing elections management systems with VoteCal.

## Other Approved HAVA Activities

**Audits.** The spending plan allocates \$1.5 million for the DOF's Office of State Audits and Evaluation (OSAE) to audit counties and vendors who receive HAVA funds. The SOS, however, now reports that federal requirements may preclude OSAE from performing the audits using HAVA's funds. Consequently, expenditure of the funds is on hold.

**Source Code Review.** The SOS's spending plan proposes spending \$1.2 million to review the computer source code used to run election equipment. At the time of the plan's approval, however, SOS failed to provide sufficient justification to gain DOF's approval. The SOS still has

not provided sufficient justification and the spending, therefore, is not authorized at this time.

**Other Activities.** The remaining activities approved in the spending plan account for less than \$3 million. These activities include paying for the printing of HAVA-compliant voter registration cards and SOS expenses related to voter education.

### **2006-07 Proposal**

**Administrative Costs Budgeted.** The Governor's budget proposes the continuation of \$1.7 million for SOS administrative costs in 2006-07. To date, SOS has not provided a workload justification for this amount of funding. The only detail provided is that \$1.1 million would be used for personnel costs, with the remainder used for other operating expenses. With HAVA requirements generally implemented by January 1, 2006, it is unclear whether these ongoing administrative expenses are warranted. The administrative costs for implementing the VoteCal project are funded separately, within the costs of the FSR.

**No Other Funds Budgeted.** As noted above in Figure 2, the spending plan anticipates more than \$60 million in additional HAVA expenditures in the budget year. Yet, the budget includes no authority for the expenditure of these funds. Presumably, in the spring, the administration will request appropriation authority for this spending.

## **CONTINUING LAO CONCERNS ON HAVA IMPLEMENTATION**

Over the past several years, we have raised a number of serious concerns with the state's approach to implementing HAVA. In our view, a number of these concerns continue to pose risks to the state, as we discuss below.

### **Lack of Required Information Continues to Cause Problems**

As a result of the piecemeal and delayed approach to implementing HAVA, the 2004-05 Budget Act required the development of the spending plan and the inclusion of specific information in that plan. As submitted and approved, the plan failed to provide most of the required information. Consequently, the Legislature has received minimal detail on the proposed spending activities in many cases. The 2006-07 Governor's Budget fails to provide the information the Legislature needs to assess proposed HAVA spending in 2006-07. As noted above, the budget submission provides no justification for its administrative expenses and no information regarding other expected expenditures. While the Legislature has approved HAVA

spending to date in order to avoid further delaying HAVA implementation, the lack of complete information continues to cause problems. As described above, a number of the HAVA components are behind schedule and/or are not being implemented. Providing the information would have required SOS to fully develop each spending proposal—with objectives, implementation strategies, and timelines.

### **Delays Impair Meeting June 2006 Election Deadline**

The SOS's delays in delivering the \$195 million in voting equipment monies—combined with ongoing delays in making voting equipment certification decisions—have impaired counties' ability to acquire and install HAVA-compliant equipment for the upcoming June 2006 primary election. Furthermore, the delayed timing of the disabled access and the training grants could reduce county effectiveness in these areas.

### **Plan Exposes General Fund to Database Costs**

Developing a state-based database and successfully integrating 58 counties as envisioned in VoteCal will be a significant undertaking. The costs of state information technology projects of this scope—particularly when involving all 58 counties—have tended to significantly exceed initial estimates. The estimate has already risen from \$47 million to \$73 million before even beginning the project. Under SOS's proposal, the project will cost the General Fund millions of dollars. The projected balance of unallocated HAVA funds would provide only minimal protection from the General Fund being responsible for any additional cost overruns.

### **Outstanding Liabilities From Federal Audit**

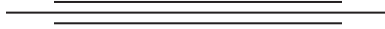
The prior SOS administration's misuse of HAVA funds has exposed the state to potential financial liabilities to repay the federal government. A recently completed audit by the U.S. Election Assistance Commission questioned the legitimacy of \$3.8 million of California's HAVA spending. While SOS is still disputing some of these amounts, the state is likely to have to repay the federal government some portion of these funds.

### **SOS Needs to Update Its Budget**

*The Secretary of State will need to update its budget to reflect proposed spending in the budget year. We withhold recommendation on these amounts pending the submittal of detailed justifications.*

As noted above, the budget currently contains no funding for HAVA activities other than administrative costs. The administration will need

to update its budget to reflect proposed spending in the budget year. We withhold recommendation on these amounts pending the submittal of detailed justifications. Unless SOS provides detailed justification for its administrative costs, we recommend the Legislature delete this funding.



## FRANCHISE TAX BOARD (1730)

The Franchise Tax Board (FTB) is one of the state's two major tax collection agencies. The FTB's primary responsibility is to administer—with the assistance of the Employment Development Department (EDD)—California's personal income tax (PIT) and corporation tax (CT) programs. The FTB also administers the Homeowners' and Renters' Assistance Programs, the Political Reform Act audit program, and the Child and Dependent Care Expense Credit. In addition, the FTB administers several non-tax-related programs, including the collection of child support payments and other court-ordered payments. The FTB is governed by a three-member board, consisting of the Director of Finance, the Chair of the Board of Equalization (BOE), and the State Controller. An executive officer, appointed by the board, administers the daily operations and functions of the FTB.

The Governor's budget proposes \$662 million (\$499 million General Fund) and 5,160 positions in support of FTB's operations. Compared to the current-year budget, this represents a decrease of \$35 million (3.6 percent) and a General Fund decrease of \$15 million.

The decrease in total funding is due almost entirely to reduced support for the California Child Support Automation System (CCSAS). This program is funded largely through reimbursements from other departments, but also receives General Fund support. The CCSAS funding is reduced by \$10.2 million in General Fund support. This system is being phased in over a number of years and is expected to receive declining General Fund support over the next several years. Elsewhere in this analysis, we discuss the past performance and current status of CCSAS and related child support collection activities (see "Health and Social Services" chapter).

The budget proposes increases for the ongoing activities associated with court-ordered debt collection programs (\$3.8 million in special funds) and retention of outside legal counsel (\$700,000 from the General Fund). These increases are partially offset by decreases due to one-time cost reductions, expiring programs, and unallocated reductions in state operations.

## REVIEW OF TWO TAX CREDITS

There are a number of special tax credits that are administered by the FTB. Below we discuss two of these programs that have significant fiscal—and policy—issues associated with them.

### **Child and Dependent Care Expense Credit**

*We recommend that the Franchise Tax Board (FTB) report at budget hearings regarding the impacts of shifting the focus of its fraud detection activities for the child and dependent care expense credit. We also recommend that the Legislature direct FTB to require additional documentation in order for taxpayers to qualify for this tax credit and to report at budget hearings on the costs and revenues associated with documentation options.*

**Background Regarding the Program.** Since January 1, 2000, California has made available to taxpayers with children or other dependents a child and dependent care expense credit (CDCEC) equal to a percentage of their expenses associated with the care of such individuals. The purpose of the credit is to partially defray expenses incurred by taxpayers who must care for children or other dependents so that the taxpayer can be employed or seek employment.

The credit is available for direct expenses associated with such care—up to \$3,000 for one child or dependent and up to \$6,000 for two or more children or dependents. The California credit is calculated as a percentage of the similar federal credit. The percentage allowed under the California program decreases as taxpayer adjusted gross income (AGI) increases. Thus, for taxpayers with AGIs of \$40,000 or less, the credit percentage is 50 percent of the federal credit; for taxpayers with annual AGIs of \$40,000 to \$70,000, the credit is 43 percent of the federal credit; and for taxpayers with AGIs of \$70,000 to \$100,000, the credit is 34 percent of the federal credit. (The credit is not available to taxpayers with annual AGIs in excess of \$100,000.)

The maximum available credit for families with at least two children or dependents ranges from \$1,050 for lower-income taxpayers to \$408 for those with incomes of between \$70,000 and \$100,000. Unlike the federal credit, the California credit is refundable. Thus, taxpayers without a tax liability can claim the credit and get a tax refund. The refundable portion of the tax credit constitutes about 75 percent of the total revenue impact to the state.

**Use of the CDCEC.** Figure 1 shows the use of the credit since its inception in 2000 through 2004 (the last year for which data are available). As shown, the revenue loss attributed to the credit grew in the first four years following its introduction, exceeding \$200 million in 2003, before tapering off in 2004 to \$183 million. This pattern is generally mirrored with respect to the actual number of taxpayers claiming the credit. (Some of the 2004 reduction was due to new fraud detection efforts put in place by FTB). The average claim during the period shown increased from \$282 in 2000 to \$306 in 2004.

**Figure 1**  
**History of CDCEC<sup>a</sup> Claims**

Tax Year	Number of Returns	Amount of Credit Claimed (in millions)	Average Credit Claimed
2000	609,245	\$171.7	\$282
2001	619,072	177.5	287
2002	661,194	196.6	297
2003	661,565	201.7	305
2004	601,258	183.8	306
<b>Totals</b>	<b>3,152,334</b>	<b>\$931.4</b>	<b>\$295<sup>b</sup></b>

<sup>a</sup> Child and dependent care expense credit.  
<sup>b</sup> Average claim over the period shown.

The use of the CDCEC by income class in 2003 (the most recent year for which such data are available) is shown in Figure 2 (see next page). About 42 percent of the total taxpayers claiming the credit earn between \$50,000 and \$100,000. Taxpayers earning between \$20,000 and \$50,000 account for an additional 45 percent of the total. (As a reference point, the median household income in California is about \$57,000.) These percentages regarding use of the credit by income class have remained relatively stable since the credit was established.

While the amount of credit claimed grew by 17 percent between 2000 and 2003, the portion of the program representing refundable credits (as opposed to credits used only to reduce tax liabilities) expanded dramatically. The refundable portion of the credit grew by over 51 percent during the same period of time, and now constitutes 74 percent of the total. As shown in Figure 2 (see next page), almost two-thirds of the refundable portion went to households in the \$20,000-to-\$50,000 AGI category. The average refundable credit has increased from \$292 to \$381 during this period.

**Figure 2****Use of CDCEC<sup>a</sup> by Income Class in Tax Year 2003**

Adjusted Gross Income	Share of Total			
	Number of Claims	Amount of Claims	Amount of Refunds	Average Claim Amount
\$0-10,000	3.0%	3.2%	4.3%	\$331
10,000-20,000	10.6	16.4	22.3	476
20,000-50,000	44.5	49.8	63.9	343
50,000-100,000	41.9	30.9	9.4	224

<sup>a</sup> Child and dependent care expense credit.

*Fraud Is a Growing Problem.* According to the FTB, the increase in the refundable portion of the CDCEC has coincided with an increase in the amount of fraudulent claims. Although the actual amount of fraud is unknown, the FTB indicates that the dollar amount of fraudulent claims detected increased from less than \$1 million in 2001 to close to an estimated \$12 million in 2004. Similarly, the average amount of fraud per fraudulent return increased from \$425 to \$588 during the period. The FTB estimates there will be a total of \$51 million in fraudulent claims over the next three years—an annual average of \$17 million.

In 2005-06, the FTB is devoting 43 personnel-years (PYs) to the administration of the CDCEC. Most of these resources (33 PYs) are devoted to fraud detection. This more than doubles the staffing for fraud detection deployed by the department in 2004-05. The FTB also indicates that its fraud efforts for the 2005 tax year are focused on taxpayers earning less than \$20,000. This segment of claimants has been the focus of the FTB fraud efforts due to the difficulty in collecting remittances from lower-income taxpayers in the event that an erroneous refundable credit payment is made.

While virtually all the CDCEC claims from lower-income taxpayers (\$20,000 AGI or lower) are for the refundable part of the credit, most of the revenue losses associated with the refundable portion of the credit are generated by taxpayers in the \$20,000-to-\$50,000 AGI category. It should also be noted that while the refundable portion represents the majority of the total amount of the credit, whether the credit amount is refunded or serves to reduce tax liabilities is immaterial from the state's revenue perspective.

The ability of taxpayers to file fraudulent returns may be in part due to the lack of independent third party reporting of actual expenses undertaken by the taxpayer. For example, to file a claim, the taxpayer fills



out the FTB credit form, but supporting documentation (such as copies of birth certificates, social security numbers, or notarized statements from the care provider) is only requested when deemed warranted by the tax agency.

There are, however, additional requirements that could be imposed on claimants to address fraud concerns. These include:

- Taxpayers providing copies of care-provider payment documents.
- Care providers filing tax returns or annual statements.
- Allow the use of only licensed care providers.

In addition, taxpayers who file fraudulent returns could be disqualified from claiming the credit for an extensive period of time in the future.

*Legislative Analyst's Office (LAO) Recommendations.* In view of the fraud problems that have been associated with the CDCEC, we recommend that the Legislature direct FTB to:

- *Report on Its Fraud Efforts.* The FTB should report on the impact of targeting its fraud efforts to focus on all areas of fraud prevalence, including the refundable and nonrefundable portions of the credit.
- *Require Additional Documentation.* To preserve the fairness and integrity of the tax credit program, we recommend that the Legislature direct FTB to require additional documentation from taxpayers in order for them to qualify for the credit. We further recommend that FTB report at budget hearings regarding the costs and revenues associated with additional documentation options.

## Enterprise Zone Costs Expanding

*We recommend that the Franchise Tax Board report at budget hearings regarding (1) the current level of audit activity of enterprise zone tax credit claims, (2) the level of anticipated audit-related workload activities in the future, and (3) the adequacy of current audit resources available for carrying out these activities.*

*Origins of Enterprise Zone Incentives.* Since the 1980s, the state has made available to expanding or relocating businesses in certain areas of the state a number of special tax programs. These tax incentives are available to businesses operating in particular areas of the state that have been designated as:

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

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

The tax incentives that are available vary somewhat depending upon zone designation, but the types of benefits that are generally available to businesses include: (1) hiring credits for a certain percentage of wages paid to employees, (2) sales and use tax credits for certain capital expenditures, (3) accelerated depreciation of purchased equipment, (4) a longer carryover of net operating business losses (NOLs), and (5) deduction of interest paid to lenders that extend credit to zone businesses.

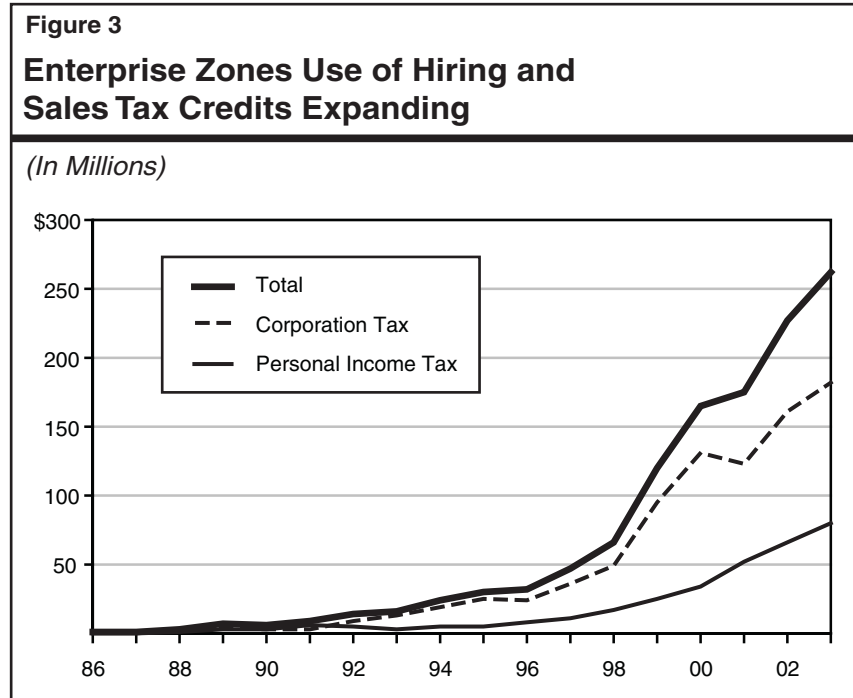
The goals of the various tax incentives are to increase private investment in particular designated areas. In attracting or stimulating such additional investment, the programs are intended to generate additional economic activity through the creation of new employment opportunities. The programs are also intended to create incentives for businesses to hire hard-to-employ individuals who might otherwise be unemployed.

The principal program among those described above is the EZ designation (the other designations indicated are relatively few in number and have a minor fiscal impact on the state). There are currently 42 separate EZs with 56 separate locations in California. In 2006, 18 of these EZs will expire unless their designated status is renewed. Another 13 expire in 2007 and 2008. The remaining 11 expire between 2009 and 2012.

***Usage of Programs Has Expanded.*** The use of the various incentive programs has expanded substantially since they were first started. Ten years ago, the total tax incentives claimed for all programs were in the low tens of millions of dollars; however, by tax year 2003, the direct revenue loss to the state had grown to \$318 million. In terms of direct revenue losses, this makes this type of business-oriented tax incentive the state's largest after the research and development tax credit.

About 70 percent of the credits that are claimed are by taxpayers filing under the CT, with the remainder claimed by businesses filing under the PIT. This later group consists of Subchapter S corporations, sole proprietorships, and limited liability corporations. Most of the credits awarded have

been allowed pursuant to the EZs—about \$282 million of the \$318 million total. Of the EZ-related credits—93 percent were related to the hiring and sales tax credits. The growth of these hiring and sales tax credits—in terms of revenue effects—has been substantial, as shown in Figure 3. The number of employees reported on tax returns has increased from 24,190 in 1999 to 75,150 in 2003.



**Geographic Tax Incentives May Not Be Effective.** Research findings regarding the impacts of geographic tax incentives—such as the EZ credits—in general are rather mixed. Overall, the dominant strain of research indicates that the response of businesses to tax incentives of this type is likely to be rather small, and the programs result in significant revenue losses relative to the benefits received. Most research indicates that these types of incentives have little impact on the overall level of economic activity or employment.

However, the research also indicates that geographically based tax incentives—while unlikely to affect *overall* economic growth in the state—can have an impact on the *distribution* of economic activity across the state. Such influence on the location of economic activity is likely to be strongest within a metropolitan area, with the impact declining as the size of the

area increases. These issues are discussed further in our December 2003 report entitled, *An Overview of California's Enterprise Zone Hiring Credit*.

***Administrative Problems Have Surfaced.*** With respect to the EZ hiring credit tax incentive program, significant administrative problems have surfaced. Many of these issues are a result of the unusual blend of state, local, and private entities that administer this program. For this credit, businesses can claim up to 50 percent of wages paid to an eligible individual. In order for businesses to claim a credit, the individual employees (for whom the credit is claimed) must meet certain criteria and provide documentation regarding their eligibility. Eligible individuals are then issued a voucher, which is presented to employers, thereby allowing the employers to claim the tax credit.

The hiring credit aspect of the EZ program relies on local administrators of the zones to carry out major functions associated with the program, including establishing and maintaining eligibility standards for employees. Administrators have relied upon interpretations of statute for guidance regarding the type of documentation necessary to establish employee eligibility. The result has been rather wide variations as to what documentation is sufficient. Some EZs have granted eligibility for certain individuals who would have been (or have been) denied by other jurisdictions. These ambiguities also have led some EZs to give vouchers to individuals who work in a different jurisdiction than the one in which the voucher was issued. A recent directive issued by the Department of Housing and Community Development (HCD) has reduced—but not eliminated—this latter practice.

***State Needs to Step In.*** The hiring credit associated with the EZ designation is a program that relies on state and local cooperation and coordination. As indicated previously, local governments and agencies provide direct day-to-day administrative support for the program. At the state level, FTB, EDD, and HCD are all involved in some aspects of the program. For example, EDD maintains much of the data regarding the eligibility status of prospective employees, while HCD provides general oversight of the EZs and conducts programmatic audits. The FTB is responsible for reviewing the tax returns of employers claiming the credit and for conducting any appropriate audit activity. Given the multiple agencies and levels of government, however, the roles, responsibilities, and authority of each of the parties have not always been completely or clearly defined.

In particular, in its compliance-related activities, FTB has uncovered situations where a claim for a tax credit may not be warranted due to ineligibility of either the employer, or the employee for whom the credit is claimed. For example, FTB has examined the documentation for certain employees and found that there were significant violations of eligibil-

ity requirements. However, FTB's authority to continue such audits was challenged by an administrative appeal to BOE (the agency responsible for income tax appeals).

Some steps are being taken to address the administrative issues discussed above. Regulations are now in the process of being formulated and adopted by HCD—an action that might eliminate or reduce many of the ambiguities and uncertainties associated with the administration of the program. In addition, the Legislature is in the process of revisiting the program and considering statutory “fixes” to some of the problems associated with it. Finally, based on a recent BOE decision, FTB can now proceed with its auditing activities regarding the validity of the vouchers associated with some of the hiring credit claims.

This BOE decision will allow FTB to “go behind” the voucher and assess the adequacy of the documentation and validity of the claim. Given the level of tax credits claimed—as well as a substantial carryover of earned but unclaimed credits, the BOE decision could result in a significant increase in audit and other compliance-related activities by FTB. These would relate not only to employee eligibility, but also to the location of the employer, the proportion of employee activities carried out in the EZ, as well as other statutory requirements of the program.

**LAO Recommendation.** Given the magnitude of the revenue impacts of the EZ hiring credit, the administrative issues that have emerged, and the likelihood that the program will continue in some form, we recommend that the Legislature direct FTB to report at budget hearings regarding: (1) the current level of audit activity of tax credit claims, (2) the level of anticipated audit-related workload activities in the future, and (3) the adequacy of current audit resources available for funding these activities.

## OTHER TAX AGENCY ISSUES

### Tax Gap Continues

*We recommend that the Franchise Tax Board report at budget hearings regarding (1) the status of its efforts to address the state's tax gap with respect to the personal income tax and the corporation tax; (2) costs and revenues associated with a misdemeanor filing enforcement program, combined use tax and income tax audits, and investigations of questionable wage withholding; and (3) the status of the required report on independent contractor withholding that was due to the Legislature last year.*

There is a substantial difference between the amount of taxes that are statutorily owed to the state and the taxes that are actually remitted by

taxpayers. This difference between owed and remitted taxes is known as the “tax gap.” Using federal estimates and state sources of information, the FTB has pegged California’s tax gap associated with PIT and CT at \$6.5 billion annually.

The FTB and federal officials indicate that the tax gap is associated with various types of activities, taxpayers, and occupations—suggesting that particular targeted efforts can be made to address the gap and limit the associated revenue losses. The gap results from underreporting of income (including claiming excess deductions from income), underpayment of taxes (including unwarranted claiming of tax credits), and nonfiling by those with California income. In terms of administrative issues, the existence of the tax gap is highly correlated to both the absence of tax withholding (such withholding currently occurs with respect to wages) and the absence of third-party reporting (such reporting occurs for interest and dividends paid). Expanding withholding and third-party reporting to other types of income or payments would help close the tax gap.

***The FTB Has Made Progress.*** The FTB has independently pursued various areas of tax noncompliance. For example, as part of the *2005-06 Budget Act*, the Legislature approved FTB programs to: (1) enhance the detection of preparers filing fraudulent returns, (2) target audits to areas of income underreporting, and (3) develop information to detect nonfilers.

***But Additional Steps Could Be Taken.*** Although some steps have been taken by FTB to reduce the tax gap, it remains a significant problem for the state. Not only does the continuation of the tax gap produce an ongoing revenue drain for the state, but continued or increased noncompliance can have a corrosive impact on the viability of the tax system itself. Although FTB is continuing its existing tax compliance efforts, the administration has proposed no new tax gap initiatives. In addition, the department has not provided the Legislature with the required supplemental report on withholding on payments to independent contractors that was due December 1, 2005. (The absence of withholding from, or adequate reporting of payments made to, independent contractors constitutes a significant portion of the tax gap.) The \$200,000 appropriation for this study was vetoed by the administration, but the study requirement remains and FTB staff have identified aspects of the study that can be accomplished using existing resources.

There are additional steps that FTB could take that would enhance its tax compliance and enforcement efforts. Some of these measures—such as a combined use tax and income tax audit program, investigations of questionable wage withholding, and pursuing misdemeanor cases of noncompliance—could generate additional revenues in the short term. Other components—such as increased data collection, maximizing audit

links to the state's other tax agencies (BOE and EDD), and examining the expanded application of withholding—would generate additional revenues in the future.

**LAO Recommendations.** In view of the magnitude of the tax gap, and the importance of a fair and efficient tax collection system to the state, we recommend that the Legislature direct FTB to report on tax gap measures that it is currently considering and the performance of its existing efforts in this regard. In addition, it should report on the costs and revenues associated with a misdemeanor filing enforcement program, combined use tax and income tax audit program, and investigations of questionable wage withholding. We also recommend that FTB report on the status of its response to the legislatively required report on independent contractor withholding.

### **Electronic Filing Saves Time and Money**

*We recommend that the Franchise Tax Board's (FTB's) budget be reduced to account for savings associated with the increase in electronic return and remittance processing and the associated reduction in the number of paper submissions. We also recommend that the Legislature require FTB to report at budget hearings regarding (1) the discrepancy between forecast and likely e-filing savings in 2006-07 and (2) the status of the new electronic filing system for business entities. (Reduce Item 1730-001-0001 by \$200,000.)*

Previously, we have noted that some of the state's tax agencies have made considerable strides in electronic remittance and return processing, including FTB. The costs associated with processing electronically filed returns and remittances are a fraction of the costs associated with paper documentation. For example, FTB has reported that about 4,800 *electronic* remittances are processed per each direct staff hour. By comparison, only 62 *paper* remittances are processed per direct staff hour. This cost differential translates directly into budget savings.

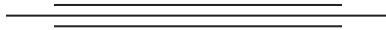
Information provided by FTB indicates ongoing growth in electronic filing of returns and remittances. This growth has occurred as a combined result of statutory mandates for tax practitioners as well as a "natural" migration from paper to electronic filing by individual and business taxpayers. The department reports that it expects 10 percent annual growth in electronic remittances through 2008, and 5 percent to 10 percent annual growth in electronic returns over the same period.

Reflecting the growth in electronic filings and remittances—and the large savings associated with the use of this technology—the department's processing budget was reduced annually from 2001-02 through 2003-04.

These reductions ranged from \$400,000 to about \$1 million. The 2005-06 budget was adjusted to account for continuing e-filing savings in 2004-05 and 2005-06.

No such budget reductions were proposed as part of the 2006-07 budget, although FTB indicates that its savings are expected to be over \$200,000. (Based on our review, this savings amount does not appear to mesh with the level of e-filing anticipated by the department.) The FTB is also bringing on line the Business Entities E-File ('BEEF') system. Although the program was not started until January 2006, budgetary savings should materialize in the near future.

Based on information provided by the department, we recommend that the Legislature reduce FTB's budget by \$200,000 for 2006-07. We also recommend that the Legislature require the department to report at hearings regarding (1) the discrepancy between forecast and likely budget savings associated with increased e-filing in 2006-07, and (2) the status of the FTB's BEEF program and the timing of additional budgetary savings.





## STATE PERSONNEL BOARD (1880)

Established by the State Constitution, the State Personnel Board (SPB) oversees many aspects of the civil service system in state government. The SPB adopts civil service rules and regulations. Duties include adopting classifications within the civil service system, conducting hearings and appeals on certain disciplinary matters, and administering the merit-based civil service hiring and promotional process. On a reimbursement basis, SPB also administers merit systems for certain local employers to ensure compliance with federal requirements. The Governor appoints, subject to Senate confirmation, the five members of SPB for ten-year terms.

The budget proposes \$19 million for SPB support in 2006-07, which is \$728,000, or 3.9 percent, more than estimated current-year expenditures. The proposed expenditures consist of \$4 million from the General Fund and \$15 million in reimbursements from state departments and other government entities.

### **Planning Is Insufficient for Proposed Web Site**

*We recommend rejecting the joint State Personnel Board and Department of Personnel Administration request for \$200,000 from the General Fund in 2006-07 and \$100,000 per year thereafter to improve the state's human resources Web site. The project is not well developed, and required planning documents have not been submitted. (Reduce Item 1880-001-0001 by \$100,000.)*

**Existing Web Sites.** Currently, just as California's personnel management system is split between SPB and the Department of Personnel Administration (DPA), the two agencies have separate Web sites. According to the administration, the two sites impede the efforts of job seekers because they both contain unique information needed by applicants and are not coordinated. The DPA reports that it has 0.5 staff positions and \$50,000 devoted to management of its Web site. The SPB reports that it has 2.5 staff positions and more than \$260,000 in resources devoted to its Web site.

**Proposal for New Web Site.** The administration requests \$100,000 from the General Fund for DPA in 2006-07 and \$50,000 per year on an ongoing basis to design and maintain a single state human resources Web site. The SPB requests an identical amount of budget authority for this joint project. Both departments say their staff members have limited expertise in the types of Web design needed to implement this project. The agencies have convened focus groups, and the proposal includes some general ideas of changes that could be made to the sites. For instance, the departments express the need to redesign existing pages in a more user-friendly format, to show total compensation packages for positions, and to allow searches for state jobs using common terminology. In general, we agree with these goals.

**Required Planning Documents Not Submitted.** The DPA and SPB have not submitted feasibility study reports (FSRs) for this project. Under state policy, FSRs are required for this project. Preparation of FSRs would have required the departments to address potentially complicated technical issues with the proposal for a new Web site. For instance, new functions of a Web site identified by DPA and SPB—such as giving departmental personnel easier access to information than they have today—create potential logistical complexities and increase the risk of additional costs. In addition, an FSR would require the departments to consider broader issues surrounding the promotion of this Web site to job seekers. Because of the importance of FSRs for project planning and budgeting, the Legislature stated its intent in the *2005-06 Budget Act* (Control Section 11.05) not to approve funding for information technology projects without an approved FSR.

**Recommend Rejecting Proposal.** Consistent with legislative policy concerning information technology projects, we recommend that DPA and SPB's joint request for funding be rejected. Should the administration wish to resubmit a similar proposal in the future, it should submit it with an approved FSR and other information addressing the concerns raised above.

---

---

## DEPARTMENT OF TECHNOLOGY SERVICES (1955)

The *2005-06 Budget Act* and the 2005 Governor's Reorganization Plan #3 created the Department of Technology Services (DTS) as the state's general-purpose information technology (IT) department. The DTS consolidated the state's two largest data centers—Stephen P. Teale Data Center and the Health and Human Services Agency Data Center (HHSDC)—and a portion of the Department of General Services related to telecommunications. The DTS provides IT and telecommunication services to most state agencies and various local jurisdictions. The HHSDC management of several large IT projects was transferred to the Health and Human Services Agency in the Office of Systems Integration.

The DTS resides within the State and Consumer Services Agency and its operational costs are reimbursed by its client agencies. The Governor's budget proposes \$235 million in expenditures from the DTS Revolving Fund, roughly the same amount as in 2005-06. Several proposals to expand services are offset by a decrease due to one-time spending in 2005-06.

### Department Needs to Identify Savings

*The Governor's budget includes no savings associated with the consolidation of the state's major data centers. We withhold recommendation on the department's budget pending receipt and review of a plan to implement efficiencies.*

**Consolidation Should Lead to Savings.** The Legislature began the process of consolidating the state's data centers in 2003-04 as a way to make the state's IT operations more efficient. For instance, a consolidated data center can use its purchasing power to negotiate better prices on hardware and software. In addition, many administrative functions can be merged to reduce staff demands.

***Budget Includes No Savings.*** The Governor's budget includes no savings associated with the creation of DTS. The department reports that it is currently reviewing its operations to identify efficiencies in five areas:

- IT contracts for hardware and software.
- Other types of contracts, such as security.
- Facilities.
- Personnel and resources.
- Telecommunications and networks.

The DTS has identified potential savings of \$4 million annually related to facilities. At the time this analysis was prepared, however, it had not completed estimates for the other areas.

***Department Should Integrate Savings Into Its Budget.*** The department should continue its efficiencies planning and report to the Legislature during budget hearings on expected savings. While some savings may require long-term efforts, we would expect other efficiencies to be implemented in the near term. Any savings for 2006-07 should be integrated into the department's budget proposal during the spring budget process. These savings would then be reflected in reduced rates for DTS' customer departments. Pending the receipt and review of such a proposal, we withhold recommendation on the department's budget.

---

---

## DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL (2100)

The Department of Alcoholic Beverage Control (ABC), established by constitutional amendment in 1954, administers the Alcoholic Beverage Control Act. Under the act, ABC has the authority to license and regulate the manufacture, sale, purchase, possession, and transportation of alcoholic beverages in California.

The Governor's budget proposes \$51.8 million for support of ABC in 2006-07, with the bulk of funding derived from the ABC Fund (\$50.7 million). Included in this amount is \$3 million for the Grant Assistance Program—representing a doubling of funding for local law enforcement recipients. In total, the proposed budget represents a 14 percent increase over estimated current-year expenditures.

### **Paid Overtime Budget**

*We recommend rejecting the request for \$1.7 million for overtime cash payments. The proposal would allow the department to drive up personnel costs without any evidence that additional overtime hours are needed to meet workload demands. (Reduce Item 2100-001-3036 by \$1,697,000.)*

**Background.** The ABC has 165 sworn peace officers responsible for enforcement activities pertaining to its 76,000 licensees throughout the state. An additional 67 nonsworn positions handle license-related investigations. To accommodate workload in both the enforcement and licensing areas, ABC has historically used voluntary overtime compensated by compensatory time off (CTO). This past practice resulted in all personnel accumulating a total of about 25,000 hours of CTO annually (just over 100 hours per employee). In 2001-02, ABC began offering licensing and enforcement personnel the option to receive cash payment for overtime hours worked rather than time off. The use of paid overtime in the past

four years has reduced the annual CTO balances to an average of 17,000 hours annually (less than 75 hours per employee). To date, the cash payment option has been funded from certain grant dollars. For instance, in 2005-06, ABC will receive about \$500,000 in such grant funding to support about 12,000 hours of paid overtime. The ABC estimates that about one-quarter of its overtime workload is for special events, and the remaining amount is for routine duties.

***Proposal to Fund Overtime Budget.*** The administration proposes a \$1.7 million augmentation from the ABC Fund to increase the department's paid overtime budget. This would support about 40,000 paid overtime hours annually. The ABC maintains that the expansion of the cash payment option is needed to further reduce CTO leave balances and to improve retention of sworn personnel.

***Proposal Not Justified.*** The proposed funding for paid overtime hours far exceeds ABC's average overtime hours. The requested funding level would increase the department's overtime hours by more than 35 percent. The department, however, provided no workload analysis to justify *any* expansion of its current overtime hours. Instead, the requested number of hours was determined based on an assumption of how many overtime hours officers would be willing to work each month. In addition, the department's proposal fails to account for the continued availability of grant funds and the preference of some employees for CTO rather than paid overtime. Finally, the department provided no rationale as to why the current approach to meeting its overtime needs is ineffective.

***Recommend Rejecting the Proposal.*** We recommend the Legislature reject ABC's request for \$1.7 million in overtime funding. The proposal would allow the department to drive up personnel costs without any evidence that additional overtime hours are needed to meet workload demands.

---

---

## EMPLOYMENT DEVELOPMENT DEPARTMENT (7100)

The Employment Development Department (EDD) is responsible for administering the Unemployment Insurance (UI) and Disability Insurance (DI) programs. The department collects from employers (1) their UI contributions, (2) the Employment Training Tax, and (3) employee contributions for DI. It also collects personal income tax withholding. In addition, it pays UI and DI benefits to eligible claimants.

The department also, with the assistance of the State Workforce Investment Board (WIB), administers the federal Workforce Investment Act Program, which provides employment and training services. Both state and local WIBs partner with EDD's Employment and Employment Related Services Program to provide services to the job seeking public. Through a network of one-stop service centers, this partnership (1) facilitates job matching services to meet the needs of businesses and job seekers; and (2) provides individualized training and services to laid-off, long term unemployed or underemployed individuals, and youth.

The budget proposes expenditures totaling \$10.8 billion from all funds for support of EDD in 2006-07. This is a decrease of \$307 million or 2.8 percent below current-year estimated expenditures. The decrease is primarily the result of revised estimates of UI and DI benefits for the budget year. The budget proposes \$24.7 million from the General Fund in 2006-07, which is an increase of \$2.5 million (11 percent) compared to the current year.

### **Workforce Investment Act (WIA) Discretionary Funds**

*The 2006-07 Budget Bill provides broad categories for the proposed expenditure of federal WIA discretionary funds. We provide details on specific initiatives within these categories so that the legislature can determine if they are consistent with legislative priorities.*

**Background.** The federal Workforce Investment Act (WIA) of 1998 replaced the Job Training Partnership Act, which provided employment and training services to unemployed and disadvantaged workers. The goal of WIA is to strengthen coordination among various employment, education, and training programs. Pursuant to federal law, 85 percent of WIA funds (an estimated \$447.6 million in 2006-07) are allocated to local WIBs. The remaining 15 percent of WIA funds (\$67.1 million) is available for discretionary purposes such as administration, statewide initiatives, and competitive grants for employment and training programs. The federal law states that all WIA funds “shall be subject to appropriation by the state Legislature.” Accordingly, we present below the Governor’s proposed expenditure plan for these funds so that the Legislature may review and ensure that it is consistent with legislative priorities.

**Governor’s Proposal.** Based on information provided by EDD, Figure 1 shows the Governor’s expenditure plan for state discretionary WIA funds. As the figure shows, administration and program services comprise \$31.9 million. These are for ongoing administration of all WIA programs. In contrast, a total of \$35.2 million is proposed for discretionary grants in three program categories. Although the specific grant programs within these categories have not changed significantly from past years, we provide more detail for each category to facilitate legislative oversight.

**Growth Industries—High Wage/High Skill Job Training.** In the past, programs funded in this area have primarily focused on providing training, support, and placement in employment in the construction trades and the automotive technology and repair industry. A separate initiative in biotechnology has funded grants to provide training in coordination with a biotechnology firm and for emergency medical technicians.

**Industries With a Statewide Need.** This area has funded programs aimed at training in the health fields, especially for nursing, in each year since 2001-02. Our review of programs funded under this category indicates that many are collaboratives headed by local WIBs. The CalWORKs agencies and community-based organizations assist in recruitment, while public or private training schools provide skills training. Labor unions or private industry may provide on-site skill training, internship, or employment opportunities. The programs usually utilize a case management approach, providing counseling, or funding for ancillary needs to encourage successful completion by trainees.

**Removing Barriers for Special Needs Populations.** Funds identified for “special needs populations” target offenders, veterans, youth, and low wage earners. Recent grants in this area have provided services to populations with significant barriers to employment; such as the homeless, recent immigrants or refugees, those with chemical dependency, limited English



skills, or out of school youth with no connection to the workforce. Most programs couple job training with other types of social services to meet the needs of these populations.

Whether to continue any of these programs is a policy decision for the Legislature.

**Figure 1**

**Workforce Investment Act (WIA)  
State Discretionary Funds  
2006-07 Proposed Expenditures**

*(In Millions)*

Budget Bill Schedule/Category	Amount
<b>(1) WIA Administration and Program Services<sup>a</sup></b>	\$31.9
<b>(2) Growth Industries</b>	
Biotechnology	\$1.0
Community colleges WIA coordination/program integration	0.6
High wage/high skill job training	2.1
Subtotal	(\$3.7)
<b>(3) Industries With a Statewide Need</b>	
Nurse education initiative	\$6.2
Nurse and other health care providers	8.0
Subtotal	(\$14.2)
<b>(4) Removing Barriers for Special Needs Populations</b>	
<b>Offenders</b>	
Parolee services	\$7.9
Female offenders treatment and employment program	1.7
<b>Veterans</b>	
Governor's award for veteran's grants	\$5.0
Veterans/disabled veterans employment services	0.7
<b>Youth and Other Special Needs</b>	
Department of education WIA coordination/program integration	\$0.5
Low wage earners and high needs populations	1.5
Subtotal	(\$17.3)
<b>Total Proposed Expenditures</b>	<b>\$67.1</b>

<sup>a</sup> Includes federally mandated activities to support 100 percent of WIA funding: capacity building, technical assistance, labor market information, audit and compliance, California Workforce Investment Board operations, policy development, and fiscal and information technology needs.

## **Proposal to Fund Veteran's Services Lacks Justification**

*The Governor's budget proposes to use \$1.5 million from the Employment Development Department Contingent Fund to increase staffing levels for employment services to veterans. We recommend rejecting this proposal because it does not provide sufficient justification for the higher staffing level. Because excess contingent funds are transferred to the General Fund, rejecting this Contingent Fund expenditure proposal will result in General Fund savings of \$1.5 million. (Reduce Item 7100-001-0185 by \$1,500,000.)*

*Background.* The state receives federal funding for the Veteran's Employment and Training Services (VETS) program based on a formula that utilizes unemployment rates and number of veterans. The VETS program consists of specialized staff within EDD's Job Services division who provide case management services to veterans to assist them in finding employment. The federal funding for the current year for this program is \$19.3 million. This funding level represents a slight increase from the \$18.4 million allocated in 2004-05. According to EDD, increased state costs, mostly for salaries and benefits, make the current federal funding allocation insufficient to maintain the 2004-05 staffing level for this program in the current year. As a result, EDD states that staffing will be reduced in the current year by 19 positions, to 191.

*Governor's Budget Proposes Using Contingent Fund to Restore Staffing.* The budget proposes to use \$1.5 million from EDD's Contingent Fund to restore funding in the budget year for the 19 positions. The proposal seeks to fund these positions with Contingent Fund for three years.

The Contingent Fund is comprised of penalties and interest levied against employers for insufficient tax or unemployment insurance withholding for employees. Any amount that remains in the Contingent Fund at the close of the fiscal year is transferred to the General Fund. In other words, using Contingent Fund for this budget proposal results in a General Fund cost.

*Governor's Proposal Lacks Justification for Staffing.* This proposal requests funds to restore staffing of the VETS program to 210 positions, the level in 2004-05. However, the department provides no specific justification for this desired staffing level. Presumably, because the VETS program is a case management service, a loss of staff would increase the ratio of cases per staff member. However, the administration has not provided evidence that such an increase in caseloads has occurred or that a corresponding impact to service quality would result from the current lower staffing levels.

We also find that the proposal overbudgets for the 19 positions, requesting all positions at the highest step of the salary scale. Typically, salaries are budgeted at no higher than midrange unless there are extenuating circumstances. If these positions were budgeted at the midlevel of the salary scale, the revised funding requirement would be \$1.2 million.

***Analyst's Recommendation.*** We recommend rejecting the proposal to use Contingent Fund for the VETS program because the department has not provided sufficient justification for the higher staffing level. This action will save \$1.5 million in General Fund.

***Other Options for Funding Veteran Services.*** In previous years, the legislature has identified services to veterans as a policy priority. Specifically, in 2001-02, the legislature directed WIA discretionary funds to the VETS program when federal funding was reduced. The Governor's budget has included this funding ever since. If the legislature wishes to direct additional funds towards the VETS programs, it could redirect from any of the program proposals outlined in the WIA discretionary funds schedule discussed previously. If the legislature chooses to redirect WIA funds, we recommend reducing the funding from \$1.5 million to \$1.2 million to reflect midrange salaries.

---

---

## DEPARTMENT OF INDUSTRIAL RELATIONS (7350)

The Department of Industrial Relations (DIR) administers several types of activities to protect the workforce from work-related injuries or deaths, improve working conditions, and ensure that workers are paid as required by law. The DIR's largest unit is the Division of Workers' Compensation (DWC), which regulates most aspects of the workers' compensation system.

The budget proposes \$347 million in spending authority for DIR in 2006-07, up \$3 million, or 0.8 percent, from estimated 2005-06 expenditures. The General Fund provides \$63 million, or 18 percent, of DIR's proposed funding in 2006-07. As recently as 2001-02, the General Fund paid for about two-thirds of DIR costs. Chapter 635, Statutes of 2003 (AB 227, Vargas), shifted costs of the workers' compensation program to employer assessments, which are deposited into the Workers' Compensation Administration Revolving Fund. In 2006-07, under the budget proposal, this revolving fund would spend \$157 million, up \$3 million, or 1.8 percent, from estimated 2005-06 spending levels.

The Legislature has authorized significant expansion of DWC since 2003-04 so that the division can implement the changes to the workers' compensation system approved in 2003 and 2004. The number of authorized positions has been expanded by about 250 to the current total of 1,169. Progress in filling positions has been slow, and as of November 30, 2005, DWC had more than 180 vacancies (16 percent of authorized staffing).

### **Recommend Transferring Unused Fund Balance to General Fund**

*The administration proposes trailer bill language to transfer the \$507,000 fund balance of the dormant Workplace Health and Safety Revolving Fund to the Workers' Compensation Administration Revolving Fund. We recommend amending the language to transfer the balance to the General Fund instead.*

**Background.** In 1989, the Legislature created the Workplace Health and Safety Revolving Fund and directed DIR to deposit into the fund civil and administrative penalties against workers' compensation insurers, self-insured employers, and others for failure to comply with the workers' compensation system. The fund paid for activities of the Commission on Health and Safety and Workers' Compensation. Chapter 6, Statutes of 2002 (AB 749, Calderon), redirects the civil and administrative penalties previously deposited to the Workplace Health and Safety Revolving Fund to the larger Workers' Compensation Administration Revolving Fund, which became the primary source of funds for DWC. Chapter 6 provides that commission activities previously funded from the Workplace Health and Safety Revolving Fund are now funded from the larger revolving fund.

**Recommend Transferring Unused Fund Balance to General Fund.** The administration proposes trailer bill language to transfer the remaining \$507,000 fund balance of the dormant Workplace Health and Safety Revolving Fund to the Workers' Compensation Administration Revolving Fund. The larger revolving fund currently has sufficient funding. Even with \$3.8 million in DWC requests to pay for increased facilities, personnel, and security costs, DIR projects that the Workers' Compensation Administration Revolving Fund will maintain a \$65 million fund balance at the end of 2006-07—43 percent of revenues (without an increase in employer assessments or other workers' compensation fees). Moreover, the fund balance of the Workplace Health and Safety Revolving Fund was accumulated during the years in which the General Fund provided the bulk of DWC funding. The monies are derived from penalties, making them eligible for transfer to the General Fund. Given the state's fiscal condition, we recommend amending the administration's trailer bill language to transfer the unused balance of the Workplace Health and Safety Revolving Fund to the General Fund.



## **DEPARTMENT OF PERSONNEL ADMINISTRATION (8380)**

The Department of Personnel Administration (DPA) represents the Governor in negotiations with state employee bargaining units concerning terms and conditions of employment. The DPA's other duties include: (1) managing certain state employee benefit programs, (2) administering parts of the classification and pay system for employees, and (3) providing legal services to departments on employment and personnel matters.

The budget proposes total expenditures of \$91 million in 2006-07, up more than \$5 million (or 6.4 percent) from 2005-06. In the proposed budget, the principal funding sources are:

- \$34 million from the General Fund for departmental operations and health care subsidies for certain state employees and retirees living in rural areas.
- \$27 million from the Flexelect Benefit Fund, principally for benefit payments to employees that set aside money for medical and dependent care.
- \$16 million in reimbursements from other departments (including more than one-half of DPA's overall budget increase, primarily due to increases for legal services).
- \$12 million from the Deferred Compensation Plan Fund for administration expenses related to the plan.

---

## BUDGET REQUESTS FOR PERSONNEL MANAGEMENT ARE A PIECEMEAL APPROACH

### No Need for Consultants to Study Personnel Reform Again

*We recommend that the Legislature reject the administration's request for \$1 million from the General Fund to pay consultants to develop a plan for reforming the state's employee classification system. If the administration wants to implement such reforms, it should propose a comprehensive plan to the Legislature instead of spending money to study piecemeal, incremental changes. (Reduce Item 8380-001-0001 by \$1 million.)*

The proposal requests a one-time augmentation of \$1 million from the General Fund so that DPA can hire consultants to provide recommendations for maintaining or changing the state's civil service classification system. The administration says that these funds would be spent over two years for the "assessment phase" of the consultants' work in developing a long-term plan.

**State Classification System.** The state civil service system now includes about 4,500 separate job classifications, nearly 90 percent of which are for specialty positions suited for a particular department. State employees are hired, paid, and retained based on their compatibility with the specific duties mentioned in the job classification. Because there are so many classifications, many of which apply to a small number of employees, the system limits managerial flexibility and can lead to disputes between employees and departments.

**Personnel Reform Has Been Studied Already.** The Little Hoover Commission, the administration's California Performance Review, our office, and others have released many reports on the need for comprehensive personnel reform, including classification reform. For instance, in a Little Hoover Commission report published in June 2005, the commission described the state's personnel practices as "calcified." In past reports, we have criticized the focus of state personnel policy on process, rather than results, and have called the classification system "stultifying" in its complexity and rigidity. While the classification system is an important component of the state's civil service system, these reports also identify a wide range of other problems, including cumbersome hiring practices, the overlapping authority of DPA and State Personnel Board (SPB), weak efforts to promote state job opportunities, the prevalence of recruitment processes open only to current employees, and poor recruitment and training of managers.

**Unclear Products.** The administration's request is vague in terms of what the state would receive from the \$1 million in consulting costs. It is unclear what products the consultants would produce. It is also uncertain how any plan would be implemented and whether the plan would be approved by SPB, which is responsible for classification changes.

**Comprehensive Reforms Need to Be Considered by the Legislature.** We continue to believe that bold, comprehensive reform of state personnel policies is necessary. This is particularly the case given the state's aging workforce. The state's civil service system will need to attract a new generation of public servants in the coming years. Improving public services and allowing state government to adapt to change should be the most important principles for reform in this area. Rather than spending another two years studying specific components of civil service reform, such as an overhaul of the classification system, we believe time and money would be better spent if the administration presented a comprehensive proposal for legislative consideration. Such a proposal would include *all* of the components, including classification reform, needed to make the state's civil service system more productive and efficient. After the administration and the Legislature agree on the principles and major components of a comprehensive reform effort, the hiring of consultants to help plan for implementation of the package might be more appropriate. We, therefore, recommend rejecting the proposal to hire consultants for a piecemeal study of classification reform.

### **One Exempt Employee Versus 100,000 Employee Retirements: An Ineffective Plan**

*We recommend rejecting the department's request for \$140,000 from the General Fund to pay for a single exempt employee who would assist departments in implementing workforce and succession plans. A single individual would be an ineffective response to the issue. (Reduce Item 8380-001-0001 by \$140,000.)*

This proposal requests an ongoing augmentation from the General Fund of \$140,000 to hire one exempt employee to act as a state "workforce planning" administrator. The individual (annual salary of \$107,000) would coordinate and manage services for departments to plan for the retirements of their staffs. We estimate that 35 percent to 45 percent of current state employees will retire in the next ten years. An even higher proportion of state managers are expected to retire over the same time period.

**A Single Position Cannot Address a Huge Problem.** State departments and agencies will cope with up to 100,000 employees retiring within the next ten years. Hiring a single individual to provide consulting and assistance services to departments would be an ineffective response to



this issue. Consequently, we recommend that the request be rejected. The administration may wish to consider a more comprehensive approach to this issue.

### **Planning Is Insufficient for Proposed Web Site**

*We recommend rejecting the joint Department of Personnel Administration and State Personnel Board request for \$200,000 from the General Fund in 2006-07 and \$100,000 per year thereafter to improve the state's human resources Web site. The project is not well developed, and required planning documents have not been submitted. (Reduce Item 8380-001-0001 by \$100,000.)*

**Existing Web Sites.** Currently, just as California's personnel management system is split between DPA and SPB, the two agencies have separate Web sites. According to the administration, the two sites impede the efforts of job seekers because they both contain unique information needed by applicants and are not coordinated. The DPA reports that it has 0.5 staff positions and \$50,000 devoted to management of its Web site. The SPB reports that it has 2.5 staff positions and more than \$260,000 in resources devoted to its Web site.

**Proposal for New Web Site.** The administration requests \$100,000 from the General Fund for DPA in 2006-07 and \$50,000 per year on an ongoing basis to design and maintain a single state human resources Web site. The SPB requests an identical amount of budget authority for this joint project. Both departments say their staff members have limited expertise in the types of Web design needed to implement this project. The agencies have convened focus groups, and the proposal includes some general ideas of changes that could be made to the sites. For instance, the departments express the need to redesign existing pages in a more user-friendly format, to show total compensation packages for positions, and to allow searches for state jobs using common terminology. In general, we agree with these goals.

**Required Planning Documents Not Submitted.** The DPA and SPB have not submitted feasibility study reports (FSRs) for this project. Under state policy, FSRs are required for this project. Preparation of FSRs would have required the departments to address potentially complicated technical issues with the proposal for a new Web site. For instance, new functions of a Web site identified by DPA and SPB—such as giving departmental personnel easier access to information than they have today—create potential logistical complexities and increase the risk of additional costs. In addition, an FSR would require the departments to consider broader issues surrounding the promotion of this Web site to job seekers. Because of the importance of FSRs for project planning and budgeting, the Leg-

islature stated its intent in the *2005-06 Budget Act* (Control Section 11.05) not to approve funding for information technology projects without an approved FSR.

***Recommend Rejecting Proposal.*** Consistent with legislative policy concerning information technology projects, we recommend that DPA and SPB's joint request for funding be rejected. Should the administration wish to resubmit a similar proposal in the future, it should submit it with an approved FSR and other information addressing the concerns raised above.

---

---

## CALIFORNIA HORSE RACING BOARD (8550)

The California Horse Racing Board (CHRB) licenses racing industry participants, enforces racing rules related to drugs and other offenses, administers efforts to protect racing horses, and oversees programs to improve the health of jockeys and other industry employees. The CHRB regulates operations at 14 racetracks, 20 simulcast facilities, and advance deposit wagering services (available via telephone or on-line). In total, the horse racing industry employs an estimated 30,000 Californians.

The state collects \$44 million from racing-related activities each year. The CHRB's appropriations are provided from special funds that receive some of these collections. The 2006-07 Governor's Budget proposes \$10.1 million of CHRB expenditures in 2006-07, up \$1.4 million (16 percent) from estimated spending in 2005-06. More than 85 percent of CHRB's proposed budget comes from the Fair and Exposition Fund. The rest comes from the Racetrack Security Fund, which receives revenues from winning tickets that are not cashed in by bettors. More than \$1.1 million of the proposed increase would come from the Racetrack Security Fund and be directed to drug testing (discussed below) and administrative hearings.

### **Board Should Explore Other Options to Keep Drug Test Costs Down**

*We recommend rejecting the request for \$851,000 from the Racetrack Security Fund to expand the California Horse Racing Board (CHRB) equine drug testing program. The CHRB should explore other options to fulfill the Legislature's mandates on drug testing and avoid increasing state costs. (Reduce Item 8550-001-0942 by \$851,000 resulting in a commensurate General Fund revenue increase.)*

**Testing Budget Prior to 2005 Legislation.** In 2004-05, the CHRB spent \$1.1 million on its equine drug testing program, which tested about 32,000 urine and blood samples. Positive drug tests result in fines or suspensions and loss of ill-gotten winnings for owners, trainers, and/or others associated with an implicated horse. Two-thirds of samples were sent to

a private laboratory chosen by competitive bid at a cost of \$540,000. The remaining one-third of samples was sent to the Kenneth L. Maddy Equine Analytical Laboratory (Maddy Lab) at the University of California, Davis. The Maddy Lab charged CHRB \$541,000—roughly twice as much per sample. One reason for the price difference is that the Maddy Lab uses more advanced technology—with broader capabilities to detect prohibited substances—than nearly all private testing facilities.

**2005 Legislation and 2005-06 Testing Budget.** In 2004 and 2005, the CHRB received reports of increasing abuse of bicarbonate mixtures (also known as “milkshakes”). Milkshakes may increase the endurance of horses and are not detected by routine testing techniques. In response, Chapter 179, Statutes of 2005 (AB 52, J. Horton), authorizes CHRB to conduct testing for milkshakes. Chapter 179 also requires CHRB to make the Maddy Lab its “primary drug testing laboratory.” The CHRB decided to move *all* of its testing—both routine and milkshake—to the Maddy Lab in 2005-06, exceeding the minimum requirements of Chapter 179. Testing expenses in 2005-06 will be an estimated \$1.3 million, up 23 percent from the prior fiscal year. (This does not include costs for milkshake testing, for which racing associations pay the Maddy Lab directly.) Because of the Maddy Lab’s higher costs, CHRB has implemented a policy that the Maddy Lab will test routine drug samples on a random basis. This means that only around two-thirds of samples collected according to CHRB rules are being tested.

**2006-07 Budget Proposal.** The budget proposes \$851,000 of new funding from the Racetrack Security Fund so that CHRB can continue to use the Maddy Lab as its sole testing facility and test all or nearly all samples collected. The annual budget act typically requires the transfer of any unencumbered Racetrack Security Fund balances to the General Fund at the end of the fiscal year. The proposed increase in CHRB spending, therefore, will result in a commensurate reduction of General Fund resources.

**Other Options Available for Testing.** We believe there are several other options that would allow CHRB to meet its legislative mandates and reduce state costs below those proposed. The CHRB could choose any of the following options:

- Testing more than 50 percent of samples at the Maddy Lab (making it the primary lab) and resuming use of other laboratories, chosen through competitive bidding, for the rest of samples.
- Continuing the practice adopted in 2005-06 of using the Maddy Lab as the only testing facility and testing most of the submitted samples, chosen randomly.

- Reducing the number of required samples each race day through regulatory changes.
- Requesting legislative authorization to charge racing associations and/or owners for the increased testing costs, similar to the way that milkshake testing is funded under Chapter 179.

***Recommend Rejecting Funding Request.*** The CHRB has not provided evidence that the integrity of California racing would decline if CHRB continues to receive its 2005-06 testing budget in the budget year. California currently tests and spends roughly the same amount on testing (per race) as the national average. Because CHRB has other options to meet its legislative mandates on drug testing, we recommend rejecting the proposal for \$851,000 of funding from the Racetrack Security Fund. This recommendation would increase General Fund resources by an equal amount.

---

---

## CALIFORNIA DEPARTMENT OF FOOD AND AGRICULTURE (8570)

The California Department of Food and Agriculture (CDFA) provides services to both producers and consumers of California's agricultural products in the areas of agricultural protection, agricultural marketing, and support to local fairs. The purpose of the agricultural protection program is to prevent the introduction and establishment of serious plant and animal pests and diseases. The agricultural marketing program markets California's agricultural products and protects consumers and producers through the enforcement of measurements, standards, and fair pricing practices. Finally, the department provides financial and administrative assistance to county and district fairs.

The budget proposes expenditures of \$285 million and 1,837 personnel-years in 2006-07 for the department, including \$105 million from the Agriculture Fund and \$92 million from the General Fund. The proposed General Fund expenditures are \$8.3 million (10 percent) higher than estimated current-year expenditures, primarily due to a \$7.2 million augmentation to address threats to food production. We discuss the threats to food production proposal in "Part V" of *The 2006-07 Budget: Perspectives and Issues* as part of the Governor's efforts to address the state's preparedness for emergencies. Below, we discuss two other proposed augmentations.

### **Shorten Pilot Program for Vehicle Inspections**

*The budget proposes a two-year pilot program to inspect private vehicles entering the state for agricultural pests. A one-year program should be sufficient to reassess the risk.*

**Background.** From 1921 to 2003, private vehicles entering California were screened for compliance with federal and state agricultural laws in an effort to minimize the introduction of pests that might cause damage to agricultural crops or native plant species. Due to fiscal constraints, the

department discontinued the private vehicle inspection program in 2003-04 at its 16 inspection stations. It was the department's assessment that the private vehicle inspections were the department's least effective method of controlling pests. Since that time, only commercial vehicles entering the state have been subject to inspections.

***Proposal for Two-Year Pilot Program.*** The department proposes to conduct a two-year pilot program for private vehicles at the Needles inspection station. The objective of the pilot program is to reassess the risk of pests from private vehicles entering the state. Specifically, the department would add five limited-term inspectors to screen private vehicles, at a cost of \$380,000 annually. Vehicles determined to present a high degree of risk would be physically inspected (for instance, trunk opened and coolers examined). The department estimates that one-third of vehicles would undergo such inspections.

***Pilot Longer Than Necessary.*** The department reports that recent surveys it conducted at two stations suggest the lack of private vehicle inspections may be contributing to an increase in quarantined agricultural products entering the state. On the basis of these surveys, the department wants to conduct a longer pilot program. In view of the state's long history with this program, one year should be sufficient to reassess the risk. We therefore recommend the Legislature approve a one-year pilot program and adopt supplemental report language declaring its intent.

## **No New Funding Needed for Hydrogen Fuels Standards**

***The budget proposes \$174,000 in General Fund support to continue the development of interim hydrogen fuel standards. We recommend the Legislature reject this request, due to the availability of carryover funds from the current-year budget. (Reduce Item 8570-001-0001 by \$174,000.)***

***Hydrogen Highway Funding.*** Existing law requires CDFG to adopt specifications for gasoline and other specified fuels for use in motor vehicles. Chapter 91, Statutes of 2005 (SB 76, Senate Committee on Budget and Fiscal Review), assigns CDFG—in conjunction with the Air Resources Board (ARB)—the responsibility for establishing and adopting specifications for hydrogen fuels by January 1, 2008. Chapter 91 appropriates \$6.5 million from the Motor Vehicle Account (MVA) to the ARB to fund the various activities related to hydrogen-powered vehicles until January 1, 2007. The ARB subsequently contracted with CDFG in 2005-06 for \$370,000 to support the development of interim fuel standards.

**Proposal.** The department proposes \$174,000 in General Fund support for continued efforts to develop interim fuel standards in 2006-07. This request would fund a limited-term staff chemist and consulting costs.

**Delays Lead to Carryover Funds.** Due to delays in implementing Chapter 91 in the current year, the department now estimates that only \$61,000 of the current-year contract will be spent this year. The budget-year proposal fails to account for the \$309,000 balance that will be available in 2006-07.

**Upcoming Status Report.** The Legislature intended for the hydrogen highway activities to be funded from the MVA. Moreover, the current-year appropriation was intended to fully fund activities through January 1, 2007. The ARB is required to report at that time on the status of program activities.

**Recommend Rejection of Request.** Given the large expected carryover balance and the upcoming status report, a request for additional funding is premature. We recommend the Legislature reject the request for \$174,000 in General Fund spending. The department should use its carryover balance to fund its activities in 2006-07. Any future funding for this activity should come from the MVA.

---

---



## DEPARTMENT OF FINANCE (8860)

The Department of Finance (DOF) advises the Governor on the fiscal condition of the state and develops the Governor's budget. The department also provides economic, financial, and demographic information. In addition, the department oversees the operation of the state's accounting and fiscal reporting system. The Office of State Audits and Evaluations assesses the operation of the state's programs. Finally, the Office of Technology, Review, Oversight, and Security serves as the administration's information technology project review unit.

The Governor's budget proposes expenditures of \$47.7 million (\$33.7 million General Fund and \$14 million reimbursements) to support the activities of DOF in 2006-07. This is an increase of \$1.1 million, or 2 percent, above estimated current-year expenditures. The department proposes to continue the development of a new budget information computer system. The budget proposes expenditures of \$3.5 million for this project, as well as the reappropriation of \$1.7 million from 2005-06 (due to delays in awarding a consulting contract). In addition, the department proposes the creation of a new unit to oversee state-reimbursable mandates, which we discuss below.

### **New Mandates Unit**

*We withhold recommendation on the department's proposal for \$537,000 to create a mandates unit, pending receipt of the department's required mandate reform proposal.*

When the state mandates that local agencies implement a new program or higher level of service, the California Constitution generally requires the state to reimburse local agencies for their costs to carry out the activities. Over the last several years, there has been considerable tension between state and local governments regarding: the process for determining whether a state law or regulation imposes a mandate, the mounting backlog

of unpaid mandates claims, and State Controller Office audit exceptions regarding local mandate claims.

To encourage the administration to participate to a greater extent in the discussions regarding mandate reform, the Legislature directed the department in the *2005-06 Budget Act* to prepare a report on the mandates reimbursement process and evaluate alternatives. This report is to be provided to the Legislature by March 1, 2006.

The 2006-07 budget proposes \$537,000 (from reimbursements) and four positions for a new mandates unit in the department. The department indicates that the new unit would develop and implement mandate reform policies. Pending receipt of the administration's proposal for mandate reform, however, we are not able to advise the Legislature regarding the need for this funding or these positions. We therefore withhold recommendation on the \$537,000 and the four positions pending receipt and review of the required report.

---

---

## COMMISSION ON STATE MANDATES (8885)

The Commission on State Mandates (commission) is responsible for determining whether local government claims for reimbursement of state-mandated local costs should be paid by the state. If the commission determines that a statute, executive order, or regulation contains a reimbursable mandate, it develops an estimate of the statewide cost of the mandated program and includes this estimate in a semiannual report.

Under Proposition 1A approved by the state's voters in 2004, the Legislature must appropriate funds in the annual budget to pay a mandate's outstanding bills, "suspend" the mandate (render it inoperative for one year), or "repeal" the mandate (permanently eliminate it or make it optional). Two categories of mandates—those relating to K-14 education and employee rights—are exempt from this payment requirement. Proposition 1A also authorizes the state to pay over a period of years unpaid noneducation mandate claims incurred prior to 2004-05.

### BUDGET PROPOSAL UNDERSTATES MANDATE COSTS

The Governor's budget includes \$240 million (General Fund) and \$1.7 million (special funds) under the commission's budget item to pay noneducation mandate claims in 2006-07. (Funding for K-14 mandates is included under the K-12 and community colleges budget items.) The \$240 million includes:

- \$98.1 million for the first year of the state's 15-year plan to repay mandate obligations incurred before 2004-05.
- \$46.2 million to pay the 2006-07 costs of all ongoing mandates.
- \$45.7 million to pay prior-year costs of mandates recently identified by the commission.

- \$50 million for an undesignated fund to transform two mental health mandates (jointly called the “AB 3632” mandates) into a categorical program.

Figure 1 summarizes our analysis of the administration’s proposal, which we discuss in greater detail below.

<b>Figure 1</b>		
<b>2006-07 Mandate Costs (Noneducation)</b>		
<i>(In Millions)</i>		
<b>Purpose of Funds</b>	<b>Budget Bill Amount (GF)</b>	<b>LAO comment</b>
<b>Funded in Budget</b>		
15-year payment of backlog	\$98.1	Amount may change after latest claims are tallied and audits are completed.
Ongoing funded mandates	46.2	We estimate costs to total about \$100 million.
Newly identified mandates	45.7	Costs may be lower, unless additional claims are identified in the spring.
Set aside for AB 3632 mandates	50.0	The total funding needed will depend on policy changes.
<b>Governor’s Budget Total</b>	<b>\$240.0</b>	
<b>Other Costs</b>		
2004-05 and 2005-06 deficiencies	—	We estimate costs to total about \$140 million.
Other unpaid mandate costs	—	We estimate costs to total about \$125 million.

### **Size of Mandate Backlog Uncertain**

*We withhold recommendation on Item 8885-299-0001, pending updated information regarding the size of the backlog from the State Controller’s Office.*

Proposition 1A authorizes the state to pay over an unspecified term of years unpaid noneducation mandate claims incurred prior to 2004-05. (Subsequent statute specified the term of this repayment plan to be 15 years.) The Governor’s budget includes \$98.1 million for the state’s payment in 2006-07 towards the backlog. At the time this analysis was prepared, the backlog of noneducation mandates dating from before 2004-05 totaled \$1.1 billion. The State Controller’s Office, however, still was tallying late mandate claims and completing mandate audits. Both these actions could affect the state’s costs to pay the backlog. Accordingly, we withhold rec-

ommendation on this item, pending updated information from the State Controller's Office.

### **Higher Cost for Mandates in the Budget Year**

*We recommend the Legislature increase Item 8885-295-0001(1) by \$54 million, or take other action to reduce the cost of these ongoing mandates.*

The administration proposes to fund in the budget year all noneducation mandates that are operative in the current year, with two exceptions. Specifically, the administration proposes to:

- Change the mental health mandates known as the AB 3632 mandates into a categorical program.
- Defer to an unspecified future date reimbursement for the Peace Officer Procedural Bill of Rights (POBOR) mandate.

Based on prior-year claims, we estimate that the cost to reimburse local agencies for the mandates the administration proposes to fund in the budget will total about \$100 million, over double the amount proposed in the budget. About \$70 million is attributable to four mandates, each costing in excess of \$15 million: Absentee Ballots, Animal Adoption, Child Abduction and Recovery, and Sexually Violent Predators.

To avoid a deficiency in the budget year, we recommend that the Legislature increase this item by \$54 million—or reduce state costs by suspending or repealing some mandates or transform them into lower-cost categorical programs. In our *Analysis of the 2005-06 Budget Bill* (please see page F-48), for example, we discuss an option for transforming the Absentee Ballots and other election-related mandates into a categorical program. In addition, given the unexpectedly high costs of the Animal Adoption mandate (discussed in 2003-04 and 2005-06 analyses), the Legislature may wish to reduce the scale of reimbursable activities of this mandate.

### **New Mandates May Cost Less**

*We withhold recommendation on Item 8885-295-0001(2) pending information regarding other, potential new mandates. We further recommend the Legislature enact legislation to clarify the date by which a new mandate must be identified for its funding to be included in the annual budget.*

Proposition 1A requires that the annual state budget include funding for the prior-year costs of new mandates (that is, those mandates recently approved by the commission). The administration has budgeted \$45.7 million for these prior-year costs. At the time this analysis was pre-

pared, the commission had adopted a statewide cost estimate for only one new noneducation mandate, totaling \$142,000. (We review this mandate later in this write-up.) We note, however, that additional noneducation mandates are working their way through the commission process and the commission might approve their cost estimates late this spring. Accordingly, we withhold recommendation on this item, pending an update from the commission as to when these cost estimates for new mandates may be adopted.

Our review also indicates that it would be advisable for the Legislature to enact legislation clarifying the state's procedures for including funds for new mandates in the annual state budget. Absent such legislation, Proposition 1A could be interpreted as requiring the state to include funds for a mandate approved on the very last day of the fiscal year. To give the Legislature and administration a reasonable amount of time to adjust the annual budget bill to include funding for new mandates, we recommend the Legislature specify in statute that funds to pay the statewide cost estimate of a new mandate adopted after March 31<sup>st</sup> would be included in the budget for the *subsequent* fiscal year.

### **Likely Current-Year Mandate Deficiency**

*We recommend the Legislature recognize an anticipated current-year mandate deficiency of \$140 million. This cost could be covered through current-year legislation or in the 2006-07 Budget Bill.*

Proposition 1A generally requires that the state pay any current-year mandate deficiency, or suspend or repeal the mandate for the coming fiscal year. Actions to suspend or repeal a mandate, however, do not eliminate the state's constitutional obligation to pay the mandate deficiency sometime in the future.

Based on claims submitted to date, we estimate that the current-year budget will not have sufficient resources to pay all claims. We estimate that the size of this current-year deficiency to be about \$140 million. The budget does not identify any funding for this purpose. The administration, however, indicates that it will propose a deficiency appropriation this spring. We recommend the Legislature recognize this anticipated current-year deficiency of \$140 million or increase Item 8885-295-0001(1) by \$140 million to provide funding to pay this deficiency in the 2006-07 Budget Bill.

### **Another Mounting Backlog of Claims**

*We recommend the Legislature pay claims for certain other unfunded mandates in full in the 2006-07 budget or include them within the state's*

---

***15-year repayment plan. In future years, we recommend the Legislature pay these claims annually to avoid incurring another large backlog of mandate claims.***

While the Constitution requires the state to reimburse local agencies for all valid mandate claims, it does not specify a payment deadline for education mandates, employee rights mandates, or any mandate that is suspended or repealed in the following fiscal year. Partly because of the lack of a payment deadline, the state has developed a significant backlog of unpaid education, employee rights, and other mandate claims.

We discuss the backlog of education mandate claims in the “K-12 Education” section of this *Analysis*. In terms of noneducation mandates, our review indicates that, by the end of 2006-07, the state will owe over \$125 million for the POBOR mandate (an employee relations mandate), and several mandates that were suspended or repealed in 2005-06 (including the Open Meetings Act and Mandate Reimbursement Process mandates).

The administration’s budget proposal does not specify a plan for paying these claims. In our view, the best option would be to fully pay these overdue claims in the budget year. Such an action would eliminate the state’s liability, as well as a source of friction between state and local government. As an alternative, it might be legally permissible for the Legislature to include these costs within its 15-year repayment plan for noneducation mandate claims. Such an action would increase these payment costs by about \$12 million annually. In future years, however, we recommend that the Legislature pay all mandate claims to avoid incurring a mounting backlog of unpaid mandate liabilities.

### **Conform Funding Level for AB 3632 Mandate With Policy Decisions**

***We recommend the Legislature conform its policy decisions regarding the AB 3632 mandates to the funding in this item. If the Legislature does not change these mandates into a categorical program—or if the new program does not begin on July 1, 2006—additional funding under this item may be needed.***

We discuss the AB 3632 mandates and the Legislature’s options in the accompanying *Perspective and Issues*. In the event that the Legislature chooses not to change these mandates into a categorical program—or the new program is not fully operational on July 1, 2006—additional funding under this item may be needed to pay the mandates’ costs. As a point of reference, we estimate that six month’s operation of the current AB 3632 mandate would cost about \$90 million.

## PROVIDE MORE INFORMATION ABOUT MANDATES IN BUDGET

The information provided in the Governor's budget and budget bill regarding mandates is highly disorganized and incomplete. The problems associated with these documents are so significant that they make it impossible for the Legislature or local agencies to understand what the administration proposes to fund for the budget year. If not corrected, these budgeting practices will undermine the Legislature's and public's ability to track mandate decision making over time. The responsibility for preparing mandate information for state budget documents rests with the Department of Finance.

***Mandate Information in Prior-Year Budgets.*** In prior years, the Governor's budget document and the budget bill as introduced provided significant information regarding the administration's mandate proposals. For each mandate, the Governor's budget specified the: (1) administration's proposal, (2) current- and prior-year funding levels, and (3) department to which the mandate was assigned for policy oversight. The budget bill, in turn, listed each mandate's appropriation and specified if the mandate was proposed for suspension in the upcoming fiscal year. Each mandate was scheduled under the budget item for its assigned state department, a practice intended to promote oversight by state agencies and budget subcommittees with expertise regarding the mandate's subject matter.

***Change in the Spring of 2005.*** The 2005-06 Governor's Budget and budget bill followed the customary practice regarding mandate information. Late in the spring of 2005, however, the administration proposed a change to reduce the administrative complexity of preparing the budget act. Specifically, the 2005-06 Budget Act consolidated most mandate appropriations (except K-14 education and two mental health mandates) under the commission's budget item. While each mandate was listed by name in the budget act, specific funding levels were not identified for each mandate.

***2006-07 Governor's Budget and 2006-07 Budget Bill.*** The 2006-07 Governor's Budget and 2006-07 Budget Bill provide less information than previous budget documents and treat K-12, community college, and non-education mandates inconsistently. The Governor's budget, for example, provides no mandate-specific information regarding noneducation mandates and little information regarding community college mandates. As a result, the Legislature cannot easily determine from the Governor's budget whether the administration proposes to fund or suspend, say, the Animal Adoption or community college collective bargaining mandates. If the Legislature looked for this information in the budget bill, it could determine that the administration proposes to fund the Animal Adoption mandate (at some unspecified amount), but still may be uncertain about



the administration's proposal for community college collective bargaining. For K-12 mandates, the Governor's budget provides mandate specific data (including costs) regarding all K-12 mandates. The budget bill, however, provides no information regarding funded K-12 mandates.

## Recommendation

*We recommend that the Department of Finance submit a report to legislative budget committees and the Joint Legislative Budget Committee before budget hearings on its plan to provide the following information in all future Governor's budgets and budget bills: (1) each mandate's name, (2) the amount proposed for each mandate, and (3) the name of each mandate proposed for a one-year suspension or repeal. We further recommend that the Governor's budget include information regarding prior- and current-year funding levels of each mandate.*

Every year, the Legislature makes decisions whether to suspend, repeal, fund, or defer specific mandates. Each action has different implications for the state's budget and local agency program obligations. The administration's changes to the state's budget documents make it exceedingly difficult for the Legislature or local agencies to understand the administration's proposals or track the Legislature's decisions regarding mandates over time. For these reasons, we recommend that the Department of Finance report to the legislative budget committees and the Joint Legislative Budget Committee before budget hearings on its plan to ensure that the following information is provided in all future Governor's budgets and budget bills: (1) each mandate's name and identifying number, (2) the budgeted amount proposed for each mandate, and (3) the name of each mandate proposed for a one-year suspension or repeal. We further recommend that the Governor's budget include information regarding prior- and current-year funding levels of each mandate.

## REVIEW OF MANDATE RECONSIDERATIONS

Over the last several years, the Legislature has requested the commission to reconsider its Statement of Decisions regarding 11 mandates. While the commission's work regarding all these mandates is not yet complete, our review of the process suggests the following:

*Use the Reconsideration Process Sparingly.* Mandate reconsiderations can be an effective way of clarifying state reimbursement obligations regarding mandates and reviewing dated mandate decisions in light of recent court decisions. Each reconsideration, however, diverts considerable commission resources from its regular activities and increases the time it takes to process pending test claims. We recommend the Legislature use

the reconsideration process only for those mandates with which it has identified a specific legal, programmatic, or fiscal concern.

*Assign Resources to the Task.* The commission is a quasi-judicial body that considers evidence submitted to it. When state and local agencies submit the information the commission needs, the commission is able to render a sound decision. In the case of some reconsiderations, however, we have noted that state agencies have declined to play an active role. For example, no state agency submitted any information into the record regarding the pending POBOR reconsideration. If the Legislature wishes the commission to reconsider a mandate, we recommend that the Legislature assign a specific state agency the responsibility for preparing information for the commission. This agency could be the Department of Finance or any state agency, but should be one with budget and legal expertise related to the mandate's policy issue.

*Draft the Reconsideration Statute Carefully.* The commission advises us that it has very limited independent authority to reconsider a mandate's Statement of Decision or reimbursement parameters and guidelines. Any statute calling for a reconsideration, therefore, must authorize the commission to consider all the relevant years and statutes associated with the mandate and to modify the mandate's parameters and guidelines. In the case of one mandate reconsideration—Extended Commitment, Youth Authority—we note that the commission's review was limited because the statute calling for the reconsideration did not cite the mandate decision test claim number and omitted one statutory reference. To avoid this legal ambiguity in the future, we recommend that new mandate reconsiderations (1) direct the commission to reconsider the mandate's Statement of Decision and parameters and guidelines and (2) specify the mandate's name and test claim number.

## SPECIFIC MANDATE ISSUES

### *Workers' Compensation Cancer Presumption*

*We recommend that the Legislature request the commission to reconsider past decisions regarding local government workers' compensation costs related to certain cases of cancer in firefighters and peace officers.*

#### **Background**

Typically, in California workers' compensation law, an employee must prove by a preponderance of the evidence that a compensable injury was

employment-related. Local governments long have been responsible for providing workers' compensation benefits to their employees. Since 1982, the Legislature has passed several laws that have significantly eased the burden of certain firefighters and peace officers in proving that cancer was caused by their public employment. These changes recognize that the services performed by state and local firefighters and peace officers sometimes result in exposure to carcinogens.

In 1984, the Board of Control (Commission on State Mandate's [CSM's] predecessor) determined that Chapter 1568, Statutes of 1982 (AB 3011, Torres)—concerning firefighters with cancer—created a reimbursable mandate for local governments. In 1992, the commission determined that Chapter 1171, Statutes of 1989 (SB 89, Torres)—concerning peace officers with cancer—created such a mandate. We estimate that these mandates currently result in about \$4 million of state-reimbursable costs annually.

### **Recommend Reconsidering Decisions**

Since the time that these mandate decisions were reached, the legal landscape regarding mandates has changed significantly. In 1998, for example, in *City of Richmond v. Commission on State Mandates*, an appellate court found that requiring local governments to provide death benefits to local safety officers under both state retirement and workers' compensation systems did not constitute a "higher level of service to the public" under the constitutional definition of a mandate. In 2004, the commission rejected a claim involving statutes passed in 1999 and 2000 that amended prior workers' compensation law concerning cancer in firefighters and peace officers. These more recent decisions seem to suggest that changing the burden of proof in workers' compensation cases may not be the type of cost covered by the State Constitution. Consequently, we recommend that the 1984 and 1992 mandate decisions be reconsidered in light of more recent judicial and commission precedent. We note that any change in the commission's mandate rulings would *not* affect firefighters' and peace officers' rights to workers' compensation benefits in any way.

Even if the commission does not change its earlier determinations that these statutes constitute reimbursable mandates, we believe that the recent changes of the workers' compensation laws—which have contributed to significant reductions of premiums and self-insurance costs since 2003—warrant a review of the parameters and guidelines for local reimbursement of these workers' compensation costs.

The following budget language would implement our recommendation:

In 2006-07, the Commission on State Mandates shall commence a reconsideration of the Statement of Decisions and parameters and

guidelines for the following mandates: (1) Cancer Presumption—Peace Officers (Test Claim Number CSM-4416) and (2) Firefighter’s Cancer Presumption (Test Claim Number CSM-4081). If the commission revises its Statements of Decision or parameters and guidelines regarding either or both of these mandates, the revised decisions and parameters and guidelines shall apply to local government activities undertaken after the date the revisions are adopted. The Department of Industrial Relations, in consultation with the Department of Finance, shall participate in the commission’s reconsideration by submitting relevant information to the commission.

## ***Newly Identified Mandate Review***

Chapter 1123, Statutes of 2002 (AB 3000, Committee on Budget), requires the Legislative Analyst’s Office to review each mandate included in CSM’s annual report of newly identified mandates. In compliance with this requirement, this analysis reviews the mandate entitled *Postmortem Examination: Unidentified Bodies, Human Remains*.

### **Postmortem Examinations Mandate**

*We recommend adoption of the Governor’s proposal to fund the Postmortem Examination: Unidentified Bodies, Human Remains mandate because the subject legislation has provided information that is currently used by law enforcement personnel to identify missing persons.*

Chapter 284, Statutes of 2000 (SB 1736, Rainey), consists of several provisions regarding the identification and investigation of unidentified bodies. The major provisions are summarized below.

- Establishes specified procedures for the autopsy of an unidentified body, when the autopsy is conducted at the discretion of the coroner. Some of these include taking available fingerprints and palm prints; conducting a dental examination; taking facial photographs; and noting significant scars, tattoos, and other marks on the body.
- Instructs coroners to retain the jaws and other tissue samples of unidentified bodies before they are buried or cremated.
- Requires law enforcement agencies that are investigating the death of an unidentified person to report the death to the Department of Justice (DOJ), in a DOJ-approved format, within ten days of the discovery of the body or human remains.

In September 2003, CSM determined that the portion of the legislation requiring law enforcement agencies to file a report of an unidentified

body to DOJ constitutes a state-reimbursable mandate. Overall costs from this mandate are estimated to be \$142,319 (from 2000-01 through 2005-06). These costs reimburse counties for labor costs associated with filling out the DOJ form.

The Governor's budget proposes to fully fund prior-year claims for this mandate.

***Analyst's Recommendation.*** We recommend adoption of the Governor's proposal to fund the mandate. The information gathered by DOJ is stored in the Unidentified Persons System, which is accessible to local law enforcement through the California Law Enforcement Telecommunications System. Additionally, the information is "cross-searched" against reports of missing persons to determine if any individuals who are reported missing are potential matches of unidentified bodies. In 2005, DOJ was able to make five confirmed physical identifications using the database. The extent to which costs will increase in the future is unknown. However, it seems unlikely costs will grow significantly in the future given that the number of reports received by DOJ has decreased from 2004 to 2005. Because the information from the DOJ report is used by law enforcement and has a relatively small cost to the state, we recommend funding the mandate.

---

---

## DEPARTMENT OF VETERANS AFFAIRS AND VETERANS' HOMES OF CALIFORNIA (8950-8966)

The Department of Veterans Affairs (DVA) provides services to California veterans and their dependents, as well as eligible members of the California National Guard. The DVA provides home and farm loans to qualifying veterans using the proceeds from the sale of general obligation and revenue bonds. The department also helps eligible veterans and their dependents obtain federal and state benefits by providing (1) claims representation, (2) subventions to county veterans service offices, and (3) educational assistance. The DVA operates veterans' homes in Yountville, Barstow, and Chula Vista, which provide medical care, rehabilitation services, and residential services.

The budget proposes total expenditures of \$315 million in 2006-07. This is \$11 million (4 percent) more than estimated current-year expenditures. Total General Fund expenditures of \$79 million are proposed, which is \$10 million (15 percent) more than the estimated current-year level. This includes support for a new Alzheimer's/Dementia Unit at Yountville and expanded behavioral health services at all three veterans' homes.

### **Salary Savings Exemption Not Justified**

*We recommend the Legislature reject a \$1.7 million proposal to exempt direct care staff from salary savings. The administration's proposal does not provide an adequate analysis of specific position problems and deviates from standard budgeting practices. (Reduce Item 8960-001-0001 by \$1,166,000; Item 8965-001-0001 by \$134,000; and Item 8966-001-0001 by \$428,000.)*

**Background.** Salary savings is the amount of reduced expenditures by a department when a position is vacant or filled at a lower salary level than the budgeted level. For example, if the salary for a position is \$4,000 per month, then the department saves \$4,000 (plus some salary driven

benefit costs) each month that the position is vacant. Every department is expected to have some salary savings as a result of normal turnover and delays in filling positions. The Governor's budget traditionally includes an assumption of salary savings for each department, and departmental appropriations are reduced accordingly. A typical level of savings is 5 percent. The budget estimates current-year salary savings of about 4.5 percent for each of the three veterans' homes.

***Department Proposes to Exempt Classifications From Salary Savings.*** The department proposes to exempt certain positions from estimated salary savings. This proposal results in increased costs of \$1.7 million across the three veterans' homes. Specifically, the proposal exempts about 20 classifications involved in direct patient care, including (1) nursing positions that require 24 hours of coverage each day and (2) other positions that may or may not require 24-hour coverage, such as dentists, nurse instructors, occupational therapists, and radiologic technicians. According to the department, the rationale for the proposal is to ensure adequate 24-hour coverage, to accommodate absences due to vacation or illness, and to provide time off for staff members who are required to monitor patients outside of normal administrative business hours.

***Exemption of Positions Not Justified.*** The department's proposal for wholesale exemption from salary savings for new and existing direct care positions is not adequately justified. Aside from providing general concerns about coverage, the request contains no analysis of specific positions that have experienced trouble with providing care. Other state hospital facilities are budgeted with standard salary savings. For example, the Department of Mental Health—which also provides 24-hour direct patient care in its hospital facilities—budgets salary savings for its staff. Departments are generally expected to use management strategies to accommodate coverage issues, such as using overtime, adjusting schedules to accommodate after-hours workload, coordinating vacation schedules, and other similar approaches. In some instances, if a department is unable to meet staffing demands with these methods, it can request additional positions based on specific workload information.

***Reject Proposal for Salary Savings Exemption.*** We recommend the Legislature reject the proposal for wholesale exemption of direct care staff from salary savings at the veterans' homes. If the department provides evidence of coverage problems for specific positions that cannot be resolved through a management approach, it could resubmit a more refined proposal.

---

---

## LOCAL GOVERNMENT FINANCING (9210)

This budget item contains funding for three purposes:

- ***Citizens' Option for Public Safety (COPS)***. The COPS program was created in 1996 to provide local governments with funds for law enforcement. The program was expanded in 2000-01 to include funding for the Juvenile Justice Crime Prevention Act. The 2006-07 budget provides \$100 million for each component. This level of funding is the same as in 2005-06, after adjusting the 2005-06 funding level to reflect some one-time carryover funds.
- ***Disaster Relief***. This program provides funds (\$1.6 million) to backfill property tax revenues lost by local governments due to specified natural disasters.
- ***Booking Fees***. The administration proposes \$40 million to re-establish payments to local agencies paying jail booking fees to counties.

### BOOKING FEES

The Governor's budget specifies that it will propose legislation to reform the booking fee program and create a \$40 million continuous appropriation to offset fees that cities and special districts pay to counties when they book suspects into county jails. At the time this analysis was prepared, the Legislature did not have details regarding the administration's proposal. This analysis provides background information regarding booking fee payments and outlines some issues for legislative consideration in reviewing the administration's proposal.

#### Background

Ever since the Legislature authorized counties to impose fees on public agencies that book their arrestees into county jails, these fees have been a



source of friction between the state, counties, and cities. The Legislature's original intent in creating this program in 1990-91 was to allow counties to recoup certain costs imposed on them by other local agencies (primarily cities), thereby offsetting state budgetary reductions associated with the 1990-91 *Budget Act*. The Legislature also intended for booking fees to provide a disincentive to local agencies booking low-level offenders into county jail, thus (1) reducing the pressure on overcrowded county detention facilities, (2) preserving county jail space for more serious offenders, and (3) giving cities an incentive to develop alternatives for nonviolent, less serious offenders.

Virtually every year beginning in 1999, the Legislature has considered proposals to offset the fiscal effect of the fees on local agencies or reduce county authority to impose fees. Most notably, Chapter 79, Statutes of 1999 (AB 1662, Leonard)—later amended by Chapter 1075, Statutes of 2000 (SB 225, Rainey), and Chapter 1076, Statutes of 2000 (AB 2219, Battin)—established a \$38.2 million continuous appropriation to annually reimburse local agencies for booking fees paid in 1997. (That is, the state reimbursement amount did not vary to reflect changes in the booking fee rate or the number of people booked into county jail.)

In 2004, however, it appeared that city and county officials and the legislative leadership reached a resolution regarding this issue. Specifically, Chapter 227, Statutes of 2004 (SB 1102, Budget and Fiscal Review Committee): (1) eliminated state booking fee subventions after July 1, 2005, and (2) limited county booking fees charged to public agencies to no more than one-half of the actual costs. Thus, current law establishes a 50-50 sharing ratio between counties and public agencies regarding the cost of booking an arrestee into county jail. (Orange, Imperial, and Ventura Counties have chosen not to charge public agencies any booking fees and a number of other counties charge less than 50 percent of the cost.)

## **Governor's Proposal**

The Governor's budget indicates an interest in "reforming" the booking fees program. Although the administration has not released its proposal, the budget indicates that the administration will propose legislation establishing a \$40 million continuous appropriation to reimburse cities and special districts for booking fees paid to counties

While details regarding the administration's proposal are not yet available, we recommend the Legislature consider these factors when reviewing the reform package:

- ***Booking Fees Are a Tiny Portion of City Law Enforcement Costs.*** While booking fee charges vary, the magnitude of booking fees as

a percent of city law enforcement expenditures is extremely low. In 2002-03 (the most recent available city financial data published by the State Controller's Office), city expenditures for police services exceeded \$6.8 billion. Total booking fees collected statewide are not known, but are not likely to represent more than one-half of 1 percent of total city law enforcement expenditures. Thus, although booking fees are a source of political friction between counties and cities, they do not represent a significant portion of city law enforcement budgets.

- ***Booking Fees Rational From a Fiscal Perspective.*** Putting a price on jail bookings has some merit from a fiscal perspective. Before the Legislature authorized counties to impose these fees, cities could use as much of a county's jail services as they wished without worrying about the costs they imposed on counties. In effect, county jails were a free good. Once cities had to pay these costs, county jail bookings by city police dropped. County authority to impose booking fees gave local agencies incentives to use county booking and detention services more efficiently.
  - ***Booking Fees Provide Incentive to Create Cost Effective Alternatives.*** Since creation of the booking fee, cities and other local agencies have expanded city jails and created programs such as "sobering centers" to treat people detained for public drunkenness. Because city jails typically house nonviolent detainees for short periods, they cost much less to operate than county jails.
  - ***Booking Fees Intended to Provide County Fiscal Relief.*** The original purpose of booking fees was to create a program whereby *cities* provided fiscal relief to *counties* to offset significant state budget reductions on counties. Should the Legislature wish to eliminate county authority to impose booking fees, it could carry out its original goal in other ways. For example, the Legislature could modify the allocation of the COPS program (funded under this item) to provide more revenues to counties and less to cities.
- 
-

## HEALTH AND DENTAL BENEFITS FOR ANNUITANTS (9650)

Through this budget item, the state contributes toward health and dental insurance premiums of more than 200,000 retired state employees, their family members, and other eligible annuitants. Retirees and other annuitants may choose to enroll in one of several plans from health maintenance and preferred provider organizations. These plans are administered by the California Public Employees' Retirement System (CalPERS), the third largest purchaser of health services in the U.S. (We discuss retiree health benefits, their costs, new accounting standards related to them, and options for the Legislature to reduce costs of this fast-growing budget item over the long term in "Part V" of *The 2006-07 Budget: Perspectives and Issues [P&I]*.)

### **Budget-Year Costs Not Yet Completely Determined**

*We withhold recommendation on the request for \$1 billion from the General Fund for annuitants' health and dental benefits pending final determination of the state's health and dental premium rates for calendar year 2007.*

The budget proposes total expenditures of \$1 billion from the General Fund for health and dental benefits for annuitants (including retired state employees, their family members, and certain others eligible under law) in 2006-07. This is \$124 million, or 14 percent, more than estimated expenditures for this purpose in the current year, as shown in Figure 1 (see next page). Although the costs initially are paid from the General Fund, the state recovers a portion of these costs (about one-third) from special funds through pro rata charges.

**Figure 1**  
**Health and Dental Benefits for Annuitants**

(Dollars in Millions)

Program	2004-05 Actual	2005-06 Estimated	2006-07 Budgeted	Change From 2005-06	
				Amount	Percent
Health	\$743.6	\$836.3	\$952.4	\$116.1	13.9%
Dental	57.1	58.9	67.0	8.1	13.8
<b>Totals</b>	<b>\$800.7</b>	<b>\$895.2</b>	<b>\$1,019.4</b>	<b>\$124.2</b>	<b>13.9%</b>

*Projected Growth in Premiums Drives Most of the Increase.* The budget request assumes that the premiums CalPERS negotiates with health plans will increase on average by 9.5 percent across its basic and Medicare plans in calendar year 2007. (Basic plans enroll most employees and retirees under age 65, and Medicare plans enroll most retirees over age 65.) Under current law, the state contributes 100 percent of the average annual costs of health premium for retired state employees and 90 percent of average costs for their family members. The rate of premium increase, therefore, is a critical factor in determining the overall amount required for this budget item each year. The more that health premiums increase, the larger the required state contribution for each annuitant. The budget also assumes comparable growth in dental premiums, which represent about 7 percent of the total funding requirement for this budget item.

*Budgeted Increase Also Reflects Accelerating Enrollment Growth.* The budgeted increase reflects estimated net enrollment growth of 4.7 percent, continuing recent trends of reported enrollment acceleration due to: (1) the aging of the large “baby boom” generation of state employees, (2) new benefits allowing some state employees to retire at lower ages, and (3) a long-term trend of increasing longevity among Californians. Since 1998, the average annual growth of retirees and others receiving state health care contributions funded in this budget item has been about 3.6 percent. We expect that a comparatively higher rate of growth in retired health plan enrollees will continue through the next several years.

*Amount Needed Depends on Negotiations With Health Plans.* The actual amount of funding needed in the budget year is dependent primarily on negotiations over health insurance premiums currently underway between CalPERS and the plans. As discussed in “Part V” of the *P&I*, CalPERS has adopted a number of initiatives in recent years—most recently by attempting to build coalitions with other large purchasers—to cut the

rapid rise in premium rates experienced by the state during the last few years. The negotiated premium rates for the 2007 calendar year should be available for review during legislative budget hearings. At that time, CalPERS may be able to provide information on whether their various cost-control efforts are working. Pending receipt of the new rates, we withhold recommendation on the amount requested under this item.

---

---

## EMPLOYEE COMPENSATION (9800)

Compensation for state employees drives a significant portion of state government's operating costs. The Governor's budget projects \$20 billion in salary and wage expenditures for 335,000 authorized personnel-years (PYs) in 2006-07 (including \$6.3 billion and more than 116,000 PYs in higher education). Figure 1 displays a breakdown of these projected 2006-07 payroll expenses (excluding benefits expenditures for items such as health insurance and retirement). As shown in the figure, higher education—consisting of the University of California (UC) and California State University (CSU) systems—represents about one-third of state payroll costs. The California Department of Corrections and Rehabilitation (CDCR) and the Department of Transportation combined represent over one-quarter of state payroll.

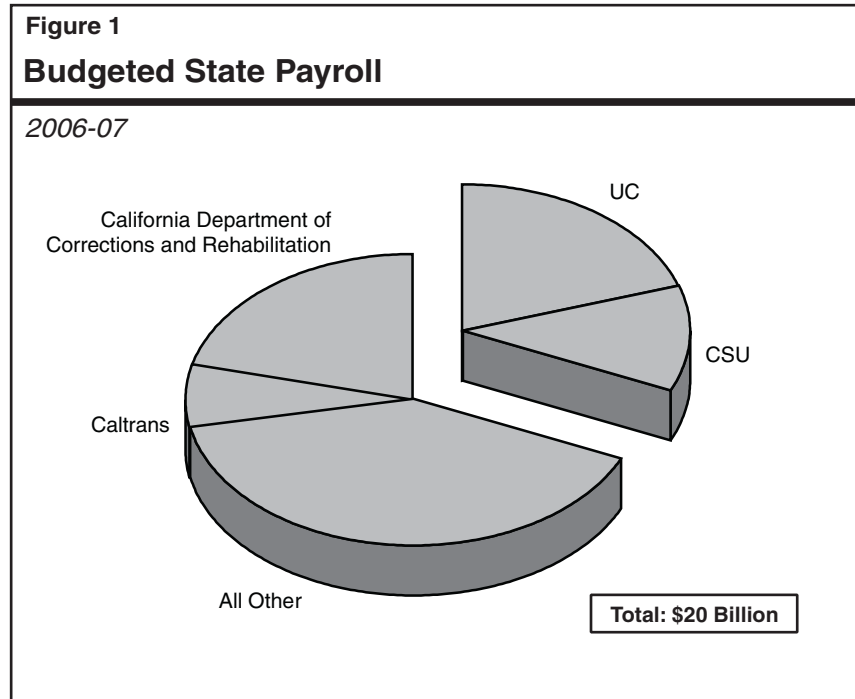
The state also pays for benefits such as health insurance and retirement, which equal almost 30 percent of salary expenditures. Thus, when benefits are included, total estimated expenditures for employee compensation are projected to exceed \$25 billion for the budget year. The General Fund supports about one-half of this total.

State civil service employees—which exclude UC and CSU employees—generally belong to one of 21 bargaining units. Figure 2 (see page 112) shows the recent history of general salary increases for state civil service employees and the consumer price indices for the United States and California.

### **Raises for Five of 21 Bargaining Units, Judges, and Others**

*The budget includes \$382 million (\$203 million General Fund) for compensation increases for: (1) memoranda of understanding with five of the 21 employee bargaining units, (2) supervisors and managers of employees in those five units, (3) judges, (4) prison medical personnel required to receive them by a court order in the Plata v. Schwarzenegger case, and (5) medical personnel in other departments.*

**Budget Item for Increases in Employee Compensation.** Baseline compensation costs already are included in departmental budgets. In the annual budget act, Item 9800, Augmentation for Employee Compensation, includes a lump sum for most additional compensation items. During the fiscal year, the Department of Finance (DOF) allocates from the lump sum to departmental budgets the amounts necessary to fund increased costs for pay and benefits in each department.



**Raises Required by MOUs Included in Budget.** Four of the state's 21 bargaining units (representing about 30 percent of rank-and-file employees) have approved memoranda of understanding (MOUs) with scheduled compensation increases in 2006-07 for some or all of their members. The tentative Unit 2 attorneys contract—awaiting legislative consideration at the time of this analysis—also includes increases. The Governor's budget includes \$303 million (\$135 million General Fund) for the increases for these five bargaining units (and for related supervisors and managers).

Among the largest components of these costs are the final raises under the state's 2001 MOUs with Unit 5 highway patrol and Unit 6 correctional officers. After these raises, these employees will have received salary

increases of about 30 percent between 2001 and 2006. Figure 3 shows the recent salary increases received by Unit 5 and Unit 6 members, as well as Unit 9 professional engineers. All of these units have MOUs that increase salaries in line with those of comparable professionals working for other public agencies.

**Figure 2**

### State Civil Service General Salary Increases

1991-92 Through 2006-07

Fiscal Year	State General Salary Increases	Consumer Price Indices	
		United States	California
1991-92	—	3.2%	3.6%
1992-93	—	3.1	3.2
1993-94	5.0%	2.6	1.8
1994-95	3.0	2.9	1.7
1995-96	—	2.7	1.4
1996-97	—	2.9	2.3
1997-98	—	1.8	2.0
1998-99	5.5	1.7	2.5
1999-00	4.0	2.9	3.1
2000-01	4.0	3.4	4.3
2001-02	—	1.8	3.0
2002-03	—	2.2	2.6
2003-04	— <sup>a</sup>	2.2	1.9
2004-05	5.0 <sup>a</sup>	3.0	3.3
2005-06 <sup>b</sup>	— <sup>a</sup>	3.6	4.8
2006-07 <sup>b</sup>	— <sup>a</sup>	2.4	2.5

<sup>a</sup> Some bargaining units received salary increases different from those listed here. In particular, Unit 5 highway patrol officers, Unit 6 correctional officers, and Unit 9 engineers received increases in part tied to increases in salaries of other California workers. See Figure 3.

<sup>b</sup> Legislative Analyst's Office's estimate of consumer price indices.

**Judges' Pay Raises.** State law generally gives judges an annual salary increase equal to the average percentage salary increase for state employees. The budget proposes \$12 million from the General Fund to provide an approximately 3.5 percent salary increase to judges. A revised estimate of the amount needed for judges' raises likely will be submitted with the May Revision. According to DOF, the administration intends to fund judges' pay



increases in the judicial branch budget beginning in 2007-08 from within funding increases tied to growth in the state appropriations limit.

*Some Compensation Increases Funded in Departmental Budgets.* In addition to the increased compensation costs budgeted in Item 9800, compensation increases are proposed in departmental budgets. For example, the 2006-07 Governor's Budget includes additional compensation required under the MOU with Unit 8 firefighters. We discuss this particular issue in the "Resources" chapter of this publication.

**Figure 3**

**General Salary Increases for Highway Patrol, Correctional Officers, and Professional Engineers**

	2003-04	2004-05	2005-06	2006-07 (Budgeted)
Unit 5—Highway Patrol	2.7%	12.1%	6.5%	4.5%
Unit 6—Correctional Officers	6.8	10.3	5.0	3.9 <sup>a</sup>
Unit 9—Professional Engineers	—	5.0	4.0-7.7 <sup>b</sup>	6.9-11.9 <sup>b</sup>

<sup>a</sup> Includes 0.9 percent increase starting June 30, 2006 and a budgeted 3.0 percent increase starting July 1, 2006.

<sup>b</sup> Varies by class based on surveys of salaries of engineers employed by California public agencies.

**Pay Hikes Related to *Plata* Lawsuit Raise Concerns**

*The budget proposes \$68 million (\$57 million General Fund) for compensation increases resulting from the Plata court order concerning prison medical staff. To date, however, the Legislature has received estimates showing that required costs total only \$21 million. Accordingly, we recommend reducing the requested amount for Plata compensation by \$47 million. (Reduce Item 9800-001-0001 by \$36,109,000. Reduce Item 9800-001-0494 by \$10,865,000.)*

*Court-Ordered Compensation Increases.* The *Plata* case concerns constitutional violations related to medical care in state correctional facilities. On December 1, 2005, the federal judge in the case ordered the state to immediately increase compensation for several classes of prison medical personnel (such as physicians, nurse practitioners, and registered nurses). The judge ordered, among other things, increases in prison medical staff's "recruitment and retention differentials." The mandatory increases in these differentials and other court requirements equal at least 10 percent of physician salaries and 18 percent of registered nurse salaries in CDCR. By

giving these prison personnel higher compensation, the order is intended to reduce position vacancies and increase retention of staff.

The Department of Personnel Administration promptly issued a pay letter to the State Controller's Office to implement the judge's order. The DOF also notified the Legislature of its intent to request funding through a supplemental appropriations bill for 2005-06 costs related to the judge's order. The administration estimated that 2005-06 costs would be \$12.2 million (\$12.1 million General Fund) and 2006-07 full-year costs would be \$20.9 million (\$20.7 million General Fund).

***Budget Funds Raises for Other Doctors and Nurses.*** The Governor's budget also proposes pay raises for doctors and nurses—an estimated additional \$47 million—in other departments with job classifications similar to those of prison staff covered by the order in the *Plata* case. To date, the administration has not provided detailed information on the rationale for this proposal or its details, such as which doctors and nurses would be given raises and how much.

***Pay Raises Should Be Discussed at the Bargaining Table.*** The Ralph C. Dills Act establishes the procedures for bargaining with units representing state civil service personnel. Offers of salary increases to address recruitment and retention (and other) problems can be discussed at the bargaining table, and the costs of these offers can be offset by financial or other concessions from employee unions. Under the Dills Act's structure, the bargaining table is the most appropriate place to settle important compensation issues. As such, the state should not voluntarily offer pay raises not required by the court order without considering the whole range of compensation and workplace issues. The proposed pay increase also could undermine the intended effect of the judge's order—by eliminating prisons' ability to offer somewhat higher salaries than other state medical positions in response to CDCR's particular difficulties in recruiting staff for their facilities.

***Recruitment and Retention Issues in Other Departments.*** The administration has not provided detailed information on how their proposed pay increases relate to any existing difficulties in recruiting and retaining medical staff in departments other than CDCR. At the bargaining table, the administration could propose compensation increases that deal specifically with any job classes most at risk of recruitment and retention problems. At the same time, the administration could more effectively use data from the comprehensive employee compensation surveys it expects to receive in March 2006. This data may be helpful for developing a strategy to more effectively target employee compensation dollars across all state job classifications.

**Recommend Funding Only Required Costs.** For these reasons, we recommend reducing the proposed funding by \$47 million (\$36 million General Fund) for medical staff compensation increases. Nonrequired compensation for all other medical personnel should be handled through the collective bargaining process, consistent with state law.

### **Most Contracts Will Have Expired and Costs May Increase**

*The budget—typical of recent practice—includes no funding for possible new memoranda of understanding (MOUs). Funding for employee compensation, therefore, is likely to exceed the amount in the budget proposal. We withhold recommendation on the remainder of the funding request to augment employee compensation pending information on any new MOUs that the administration negotiates with state bargaining units.*

**Up to 90 Percent of State Employees Will Have Expired Contracts in 2006-07.** As shown in Figure 4 (see next page), only two bargaining units (those representing protective services and professional engineering personnel) have current MOUs that extend through 2006-07. Combined, these two bargaining units represent only about 10 percent of the state's rank-and-file employees. Attorneys—another 2 percent of the state workforce—have a tentative MOU awaiting legislative consideration.

**New Contracts, if Any, Probably Will Increase Costs.** The budget includes no funds for employee compensation costs of new MOUs that may be negotiated between the administration and bargaining units. This method of budgeting Item 9800 reflects prior practice and attempts to preserve the confidentiality of the administration's negotiating strategy. In other words, the budget does not disclose the total amount of compensation increases state negotiators would be willing to give to unionized employees. New MOUs, if any, probably will increase costs above those included in the budget proposal. It would cost about \$120 million (\$65 million General Fund) for each 1 percent salary increase to state personnel associated with the 18 units without a current or tentative MOU extending to the end of the 2006-07 fiscal year.

**Even With No New MOUs, Health Costs Will Increase.** In general, pay and benefit provisions of prior MOUs remain in effect until the Legislature approves newly negotiated MOUs. Two-thirds of MOUs with state employee unions require the state to pay a specific percentage of average health plan premium costs for employees and their dependents. For these types of MOUs, this means that, if state health plan premiums rise in 2007 (as expected), the amount the state must contribute to pay for health premiums will increase—even without new MOU agreements.

(Seven bargaining units have MOUs with a “flat” state contribution for health premiums—that is, a specific dollar amount and not a percentage of premiums.)

For this reason, even if there are no new MOUs negotiated, costs for health, dental, and vision benefits could increase by up to \$120 million—about one-third from the General Fund—for rank-and-file personnel, assuming a 10 percent increase in 2007 state health plan premiums. The Governor’s budget includes no funding for these potential increased costs.

**Figure 4****Status of Memoranda of Understanding (MOUs)**

<b>Unit Number</b>	<b>Bargaining Unit</b>
<b>MOUs Continuing Through 2006-07</b>	
7	Protective Services and Public Safety
9	Professional Engineers
<b>MOUs Awaiting Legislative Action</b>	
2	Attorneys, Administrative Law Judges, and Hearing Officers
<b>MOUs Expiring on or Before July 2, 2006</b>	
5	Highway Patrol
6	Corrections
8	Firefighters
10	Professional Scientific
16	Physicians, Dentists, and Podiatrists
18	Psychiatric Technicians
19	Health and Social Services/Professional
<b>MOUs Currently Expired</b>	
1	Administrative, Financial, and Staff Services
3	Educators and Librarians (Institutional Settings)
4	Office and Allied
11	Engineering and Scientific Technicians
12	Craft and Maintenance
13	Stationary Engineer
14	Printing Trades
15	Allied Services (Custodial, Food, Laundry)
17	Registered Nurses
20	Medical and Social Services
21	Education, Consultants, and Librarians (Noninstitutional Settings)

***Withhold Recommendation Pending MOU Negotiations.*** Because of the uncertainty of required state costs for health premiums and other types of compensation, we withhold recommendation on the remainder of the budget proposal to augment employee compensation.

=====

## MIDYEAR BUDGET REDUCTIONS (CONTROL SECTIONS 3.45, 4.05, AND 4.06)

These control sections provide the administration with authority to reduce departmental General Fund appropriations during the year, after the budget is enacted. In total, the Governor's budget assumes that these control sections will reduce state General Fund expenditures by \$258 million in 2006-07. Specifically:

- **Control Section 3.45—Salaries and Wages.** The administration proposes to reduce each department's personnel budget by 1 percent. The budget assumes \$58 million in savings from this section. The administration expects to achieve these savings primarily by holding positions vacant for a longer period of time.
- **Control Section 4.05—One-Time Reductions.** The budget assumes \$200 million in one-time savings from this section.
- **Control Section 4.06—25 Percent Reductions.** This section allows the administration—"notwithstanding any other provision of law"—to reduce appropriations by up to 25 percent "when it is deemed to be in the interest of the state." Proposition 98 appropriations would be excluded. The budget does not assume any savings from this section.

### Past Authority Has Not Achieved Intended Objectives

Over the past few years, the state budget has included a variety of control sections similar to the ones proposed for 2006-07. These sections are summarized in Figure 1. The state's experience with these sections raises a number of concerns, which we discuss below.

**Savings Scored but Never Achieved.** Recent budget plans have assumed sizable savings from these types of sections. As shown in Figure 1, recent annual estimates have ranged from \$100 million to \$750 million.

In reality, these savings are rarely achieved. As a result, in such cases the enacted budget overstates the expected budgetary reserve—often by hundreds of millions of dollars.

<b>Figure 1</b> <b>Recent Midyear Budget Reduction Provisions</b>		
<i>(General Fund Dollars)</i>		
Year	Provisions	Comment
2002-03	<b>Section 3.90</b> —Required \$750 million in state operations reductions. Each reduction was limited to 5 percent.	Identified savings were less than half of the required amount.
2003-04	<b>Section 4.10</b> —Required savings of \$181 million. Allowed reductions to state operations appropriations by up to 15 percent. <b>Sections 55 and 56 of Chapter 228, Statutes of 2003 (AB 1756, Oropeza)</b> —Allowed reductions and reallocation of appropriations within a department to address unexpected costs. Contained no percentage limits. <b>Section 27.00</b> —Allowed a reduction to an appropriation of up to 5 percent to pay for a deficiency.	Some reductions shifted costs to the deficiency process, rather than reduce expenditures. Authority under Chapter 228 and Section 27.00 were used infrequently.
2004-05	<b>Section 4.10</b> —Required \$300 million in savings (half from efficiencies and half from reorganizations). State operations appropriations could be reduced by up to 20 percent, and local assistance appropriations could be reduced by up to 5 percent.	Administration only identified \$58 million of the required \$300 million in savings. Most of the savings would have occurred “on the natural,” such as from caseload adjustments.
2005-06	<b>Section 4.05</b> —Requires \$100 million in savings.	Administration identified \$100 million of savings in December 2005. Virtually all savings would have occurred on the natural.

*Program Impact Unknown.* The reductions that have been implemented are typically done with almost no detail provided to the Legislature regarding their programmatic impact. It is often months or years later that the Legislature discovers that programs that were reduced are no longer functioning as expected. For example, the 2006-07 budget contains

a number of proposals to provide augmentations to replace funding that was eliminated in midyear reductions in prior years.

***Reductions Reflect Administration's—Not Legislature's—Priorities.*** Any unallocated reduction authority given to the administration will expose legislative priorities to reductions. An administration naturally will protect its own priorities and sacrifice programs that it deems less important. For example, in the health area, previous reductions have targeted a prostate cancer treatment program and Medi-Cal antifraud activities—both of which were priorities of the Legislature.

### **Delete Sections for More Honest Budgeting**

***The proposed control sections are unlikely to achieve their targeted levels of savings. In addition, they potentially represent a significant delegation of the Legislature's authority. Consequently, we recommend that the Legislature delete the sections from the budget bill. (Delete Control Sections 3.45, 4.05, and 4.06.)***

***Savings Unlikely to Be Achieved.*** Based on recent experience, we estimate that only a fraction of the assumed budget savings would be achieved. Over the past two years, most of the savings identified have not been from cost reductions or improved efficiencies. Instead, the administration counts caseload reductions, increased federal offsets, or similar issues as savings. These types of savings typically are captured on the natural in the “unidentifiable savings” category of the budget. When these types of savings are instead scored under a control section, the practical effect is to reduce the unidentifiable savings item on a dollar-for-dollar basis. The budget, however, assumes the state will still achieve unidentifiable savings in 2006-07 (\$340 million).

***Recommend Deleting Control Sections.*** Given the consistent failure of control sections to achieve desired savings and the loss of legislative authority, we recommend that all three sections be deleted from the budget bill. The administration should identify any *specific* proposed savings in departmental budgets during the spring budget process. This would allow the Legislature to understand any programmatic impact from the reductions and protect its own priorities. Moreover, if the administration desires to make appropriation changes once the budget is enacted, it can seek statutory changes. For example, the Legislature adopted midyear savings totaling \$2.2 billion for the 2001-02 fiscal year in this manner.

---

---



## RETIREMENT CONTRIBUTIONS (CONTROL SECTION 3.60)

This control section specifies the state's contribution rates for the various retirement classes of state employees in the California Public Employees' Retirement System (CalPERS). The State Constitution gives public retirement boards, such as CalPERS' Board of Administration, the exclusive power to undertake actuarial reviews of the financial soundness of their retirement funds and to administer the funds so that members and beneficiaries receive the benefits to which they are entitled by law.

The control section also authorizes the Department of Finance to adjust any appropriation in the budget bill as required to conform with changes in the state's retirement contribution rates. In addition, the section requires the State Controller to offset retirement contributions with any surplus funds in the employer accounts of the retirement trust fund.

### **Retirement System's New Policy Should Reduce Rate Volatility**

*The retirement contribution rates set by CalPERS for the state and many local governments were volatile in the late 1990s and the early part of this decade. Governments had difficulty predicting annual contributions during their budgeting process. In 2005, CalPERS adopted a comprehensive rate stabilization policy. We believe the new policy promises more stability in contribution rates for the state and other public entities.*

#### ***How Does CalPERS Calculate Required Contribution Rates?***

Annual employer contributions to CalPERS and most other retirement systems consist of two parts—the normal cost and costs related to any unfunded liabilities. These costs are determined using the results of actuarial studies that CalPERS updates annually.

The normal cost is the average annual cost of retirement benefits earned by an employee in a given year of service. In other words, it is the amount (usually expressed as a percentage of payroll) the plan needs to invest,

earning the assumed returns over time, to accumulate enough assets to pay the retirement benefits when the employee retires.

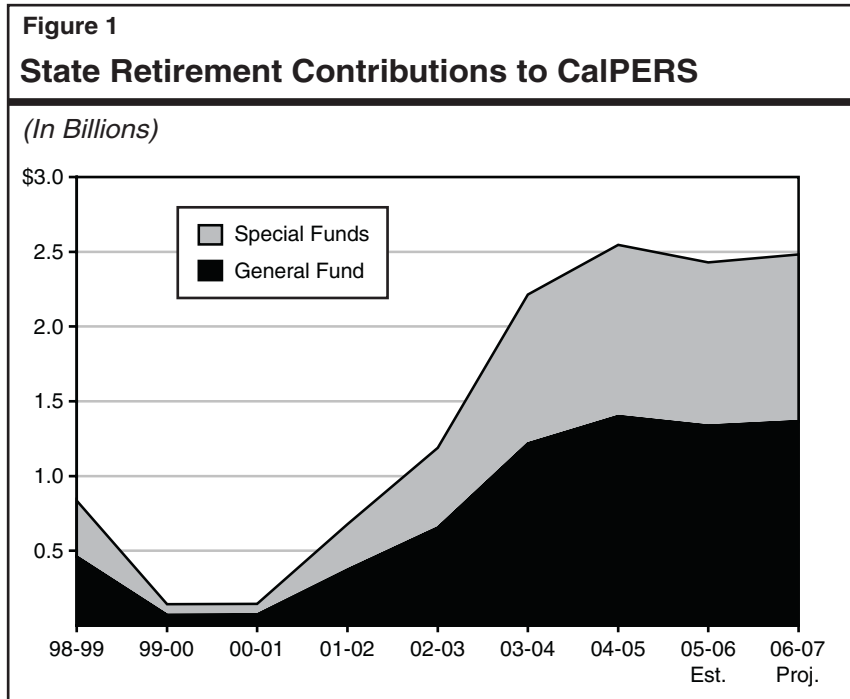
For several reasons, the normal cost collected over time and invested can be insufficient to pay future retirement benefits. This shortfall is known as an unfunded liability. Unfunded liabilities can arise when investment returns fall short of expectations, benefit enhancements are applied retroactively, or the demographics of retirees do not conform to past assumptions. Retirement contribution rates set by CalPERS include a component to pay off this unfunded liability over a specified number of years. In order to moderate fluctuation in retirement contribution rates, CalPERS and other pension systems spread out—or “smooth”—the recognition of investment and other types of gains and losses over multiple years.

***A Recent History of Volatile Contribution Rates.*** In *The 2005-06 Budget: Perspectives and Issues (P&I)*, we discussed the issue of public pension benefits and costs. Among the issues discussed was the volatility of rates that public employers have been required to contribute to retirement systems, despite policies described above to reduce such fluctuations. After the bull market of the 1990s greatly improved the funding of pension systems, many systems reduced required employer contributions substantially. Figure 1 illustrates how the state’s required contributions to CalPERS’ dropped to minimal amounts in 1999-00 and 2000-01. Other pension systems—throughout California and the nation—also reduced required contribution rates for public employers. At about the same time, the state and many local governments increased retirement benefits, which used up surplus assets and increased the annual normal cost of pension funding. When the stock markets declined, plans experienced consecutive years of less-than-expected investment returns. This double whammy—major asset losses and higher benefit costs—led to rapid increases in required employer contribution rates. Figure 1 shows how state contributions to CalPERS dramatically increased between 2001 and 2004.

***New CalPERS Rate Stabilization Policy.*** In the spring of 2005, CalPERS actuarial staff analyzed 34 possible methods to reduce fluctuations in contribution rates and presented a recommendation to the system’s board. In April 2005, the board adopted an approach recommended by its chief actuary. The rate stabilization policy applies to all CalPERS pension plans, including those for the state.

Perhaps the most important part of the new policy is a rule that gains and losses in the value of CalPERS assets will be built into the actuarial calculation of the plans’ asset value over 15 years instead of three years (the previous policy). These calculations are important because they go into CalPERS’ annual assessment of the plans’ unfunded liabilities. The

new policy means that, when the stock markets experience periods of large declines (like they did beginning in 2001), the unfunded liability that drives a part of employers' annual CalPERS contribution will grow much more slowly than it did in the past. Conversely, when the markets increase in value rapidly (as they did in the 1990s), unfunded liabilities will drop much more slowly than they did previously. For these reasons, employer contribution rates will be much more stable.



The new policy also provides for a minimum employer contribution rate set equal to the employer normal cost less the value of any system surplus (which can be created after periods of large gains in the stock market) spread out over 30 years. This policy reduces the possibility of contribution rates dropping to zero or near zero, as they did for many California public employers several years ago.

**Plan Should Provide Stability.** The CalPERS staff conducted extensive quantitative analysis of the possible impacts of a rate stabilization policy. The plan adopted by CalPERS was estimated to cut prospective volatility in employer rates by one-half. By reducing the responsiveness of employer contribution rates to sudden changes in the stock market, the new policy should address this major problem with the pension funding system that

we discussed in the 2005-06 *P&I*. There is little reason for state contributions to ramp up or down in a rapid rush to compensate for what could be temporary changes in the stock market. Therefore, we believe that the new approach of gradually moving employer contribution rates is an appropriate way for CalPERS to meet its funding obligations.

***Policy Does Not Eliminate All Risk on Retirement Rates.*** This new policy does not eliminate all risks of pension rate increases. Extended periods of declining investment returns or changed demographic assumptions about state retirees could affect future rates. In addition, any future legislative action to enhance retirement benefits can still result in increased contribution rates. (The state's employer contribution rates, for example, may increase when the effects of new retirement benefits adopted in 2002 for correctional officers and firefighters are incorporated in CalPERS rates in 2007.) The Legislature, therefore, will still need to consider carefully the possible long-term costs of any future proposed enhancement of retirement benefits.

### **Projected State Contribution Rates Down Slightly**

***Because of healthy investment returns, CalPERS projects that required state contribution rates will decline slightly in 2006-07. This projection appears reasonable, but we withhold recommendation on 2006-07 contribution rates for retirement benefits pending their final determination by the CalPERS board based on the system's annual actuarial valuation.***

CalPERS first utilized its new rate stabilization policy in setting 2005-06 rates. CalPERS staff estimate that required state retirement contribution rates will decline slightly in 2006-07 for all retirement categories, as shown in Figure 2. More than one-half of the state's contribution is for "Miscellaneous Tier 1" employees, and another one-fourth is for peace officers and firefighters.

***Healthy Investment Returns Help Reduce Rates.*** The CalPERS sets rates based on actuarial valuations of the system's condition two fiscal years ago, so that 2006-07 rates will be based principally on the retirement system's financial condition, as of June 30, 2005. In 2004-05, CalPERS assets grew in value by 13 percent, compared to the system's normal projected investment return of under 8 percent annually. This healthy investment performance was led by the nearly 38 percent return on the system's real estate investments. These investment returns are the principal factor resulting in projected lower contribution rates for 2006-07.

**Total State Contributions Should Rise, Due to Larger Payroll.** While required contribution rates are projected to decline slightly, the state's total contributions should increase slightly, as shown in Figure 1. This is because the state payroll is growing. The system's standard actuarial assumption is that state payroll grows by 3.25 percent annually. Utilizing this assumption, CalPERS projects that total state contributions will grow from \$2.4 billion in 2005-06 to \$2.5 billion in 2006-07, up 2.2 percent. Over one-half of this amount (an estimated \$1.4 billion) will be paid from the General Fund.

**Figure 2****State Retirement Contribution Rates***1991-92 Through 2006-07 (As Percent of Payroll)*

Fiscal Year	Misc. Tier 1	Misc. Tier 2	Industrial	Safety	Peace Officer/Firefighter	Highway Patrol
1991-92	11.8%	4.0%	13.4%	17.4%	17.4%	21.7%
1992-93	10.3	3.4	12.0	15.7	15.6	17.1
1993-94	9.9	5.0	11.8	15.5	15.2	16.9
1994-95	9.9	5.9	10.6	13.9	12.8	15.6
1995-96	12.4	8.3	9.0	14.2	14.4	14.8
1996-97	13.1	9.3	9.3	14.7	15.4	15.9
1997-98	12.7	9.8	9.0	13.8	15.3	15.5
1998-99	8.5	6.4	4.6	9.4	9.6	13.5
1999-00	1.5	—	—	7.5	—	17.3
2000-01	—	—	—	6.8	2.7	13.7
2001-02	4.2	—	0.4	12.9	9.6	16.9
2002-03	7.4	2.8	2.9	17.1	13.9	23.1
2003-04	14.8	10.3	11.1	21.9	20.3	32.7
2004-05	17.0	13.2	16.4	20.8	23.8	33.4
2005-06	15.9	15.9	17.1	19.0	23.6	26.4
2006-07 <sup>a</sup>	15.7	15.7	17.0	18.9	23.4	26.3

<sup>a</sup> California Public Employees' Retirement System estimates.

**Withhold Recommendation.** The projections in the 2006-07 Governor's Budget appear reasonable, but we withhold recommendation on the control section pending final consideration of required contribution rates by the CalPERS board this spring.

**No Pension Obligation Bonds Are Assumed in Budget**

*In November 2005, a court found that the legislation authorizing the sale of pension obligation bonds was unconstitutional. The Governor's budget assumes that no pension obligation bonds will be issued in the current or budget years.*

In 2004, the Legislature enacted a law authorizing the sale of up to \$2 billion in pension obligation bonds to fund the state's obligations to CalPERS. The 2005-06 budget package assumed that the bonds would be issued in 2005-06, with a net benefit to the state's General Fund of \$525 million. In November 2005, a Sacramento County Superior Court judge found that the legislation authorizing the bonds was unconstitutional because it had not been approved by voters. The state intends to appeal the decision, but the Governor's budget assumes that no pension obligation bonds will be issued in 2005-06 or 2006-07.

---

---

# FINDINGS AND RECOMMENDATIONS

## *General Government*

### Analysis

### Page

### Governor's Office

- F-13     ■ **Reject Automatic Spending Increases. Reduce Item 0500-001-0001 by \$71,000.** Recommend rejecting the administration's proposal to increase the Governor's Office budget annually on an automatic basis. The administration has offered no policy rationale as to why the current process is not working.

### Secretary for Business, Transportation, and Housing

- F-17     ■ **Tourism Marketing Augmentation Not Justified. Reduce Item 0520-001-0001 by \$2.7 Million.** Recommend rejecting the administration's proposal to increase General Fund support of the tourism marketing program by \$2.7 million. Also recommend making the existing contribution contingent on industry meeting its targeted contribution level. The value of the subsidy of the tourism industry is questionable.

### Office of Emergency Services

- F-19     ■ **Accounting Problems Continue.** Withhold recommendation on funding for the department's Law Enforcement and Victim Services division pending review of an action plan to resolve accounting problems.
- F-20     ■ **Recommend Rejecting New Criminal Justice Programs. Reduce Item 0690-002-0001 by \$300,000, Item 0690-002-0425 by \$94,000, Item 0690-102-0001 by \$5.7 Million, and Item 0690-102-0425 by \$1 Million.** Recommend rejecting the

**Analysis****Page**

administration's proposals for two new grant programs related to sexual assault and victim services. Neither proposal is well developed.

**Department of Insurance**

- F-23     ■     **Budget for Health Provider Complaint Unit Should Be Reduced. Reduce Item 0845-001-0217 by \$410,000.** Recommend appropriating \$752,000 from the Insurance Fund and approving five new positions (five less than proposed) to administer two new laws protecting health care providers and consumers. Recommend that the Legislature adopt supplemental report language requiring the department to report annually for the next three years on the workload resulting from the new laws.

**California Gambling Control Commission**

- F-26     ■     **Recommend Commission Be Funded Entirely From Special Funds and a Smaller Staff Expansion Than Proposed. Reduce Item 0855-001-0001 by \$725,000. Increase Item 0855-001-0367 by \$290,000.** Recommend rejecting proposal to change existing policy and pay for some commission costs from the General Fund. Commission operations should continue to be supported entirely by special funds with fees and charges for gambling-related activities. Recommend rejecting commission's request to expand its audit staff by six positions. Recommend approving three proposed positions for a new field inspection program on a two-year limited-term basis.

**Board of Equalization (BOE)**

- F-31     ■     **Cost-Allocation Model for Sales and Use Tax (SUT). Reduce Item 0860-001-0001 by \$6 Million and Increase Reimbursements by an Identical Amount.** Recommend enactment of legislation implementing a new simplified methodology for allocating costs associated with administering the SUT on behalf of various taxing entities. Also recommend the Legislature consider statutory changes that would allow for allocating administrative costs to all tax programs within the SUT program.



---

**Analysis****Page**

- F-36 ■ **Sales and Use Tax Gap.** Recommend that the BOE provide additional information at budget hearings regarding additional proposals for curtailing tax noncompliance.
- F-41 ■ **Electronic Technology Planning.** Recommend that BOE report at budget hearings regarding its medium- to long-term implementation goals regarding electronic registration and filing technology including estimates of related savings and costs.

**Secretary of State**

- F-43 ■ **Continuing Concerns With Help America Vote Act (HAVA) Implementation.** The Secretary of State has not provided any details regarding its proposed budget-year implementation of HAVA. The department's plan also exposes the General Fund to costs to develop a statewide voter registration database. Withhold recommendation on HAVA activities pending the submittal of detailed justifications.

**Franchise Tax Board**

- F-54 ■ **Child and Dependent Care Expense Credit.** Recommend that the Legislature direct the Franchise Tax Board (FTB) to report at budget hearings regarding the impacts of shifting the focus of its fraud detection activities for the child and dependent care expense credit. Also, recommend that the Legislature direct FTB to require additional documentation in order for taxpayers to qualify for this credit and to report at budget hearings on the costs and revenues associated with the documentation options.
- F-57 ■ **Enterprise Zone Tax Incentives.** Recommend that the Legislature direct FTB to report at budget hearings regarding: (1) the current level of audit activity of enterprise zone tax credit claims, (2) the level of anticipated audit workload activity in the future, and (3) the adequacy of current audit resources available for carrying out these activities.

**Analysis****Page**

- F-61 ■ **Tax Gap.** Recommend that the Legislature direct FTB to report on: (1) tax gap measures that it is currently considering and the performance of its existing efforts in this regard; (2) costs and revenues associated with a misdemeanor filing enforcement program, combined use tax and income tax audit program, and investigations of questionable wage withholding; and (3) its response to the supplemental report on independent contractor withholding required pursuant to the *2005-06 Budget Act*.
- F-63 ■ **Electronic Filing. Reduce Item 1730-001-0001 by \$200,000.** Recommend that the Legislature reduce FTB's budget to account for savings associated with the increase in electronic return and remittance processing and the accompanying reduction in the number of paper submissions. Also recommend that the Legislature direct FTB to report at budget hearings regarding the reduced savings for e-filing and the status of electronic filing by business entities and the related potential savings in the budget year.

**State Personnel Board**

- F-65 ■ **Planning Is Insufficient for Proposed Web Site. Reduce Item 1880-001-0001 by \$100,000.** Recommend rejecting the joint Department of Personnel Administration and State Personnel Board General Fund request to improve the state's human resources Web sites. The project is not well developed, and required planning documents have not been submitted.

**Department of Technology Services**

- F-67 ■ **Department Needs to Identify Savings.** Withhold recommendation on the consolidated data center's budget pending receipt and review of a plan to implement efficiencies.

---

**Analysis****Page****Department of Alcoholic Beverage Control**

- F-69     ■     **Reject Paid Overtime Budget. Reduce Item 2100-001-3036 by \$1,697,000.** Recommend rejecting a proposal for \$1.7 million in overtime costs. The proposal would allow the department to drive up personnel costs without any evidence that additional overtime hours are needed to meet workload demands.

**Employment Development Department**

- F-71     ■     **Workforce Investment Act (WIA) Discretionary Funds.** The Budget bill schedules the broad categories proposed for available WIA discretionary funds. Included in these categories are three project areas which are funded through competitive grants. We provide more detail on initiatives in these areas so that the legislature can determine if they are consistent with legislative priorities.
- F-74     ■     **Proposal to fund Veteran's Services Lacks Justification. Reduce Item 7100-001-0185 by \$1,500,000.** The Governor's budget proposes to use \$1.5 million from the Employment Development Department (EDD) Contingent Fund to restore staffing to 2004-05 levels for employment services to veterans. We recommend rejecting this proposal because it does not provide sufficient justification of the programmatic need for the higher staffing level. Because excess EDD Contingent funds are transferred to the General Fund, this will result in General Fund savings of \$1.5 million.

**Department of Industrial Relations**

- F-76     ■     **Recommend Transferring Unused Balance to General Fund.** Recommend amending the administration's proposed trailer bill language to transfer the \$507,000 fund balance of the dormant Workplace Health and Safety Revolving Fund to the Workers' Compensation Administration Revolving Fund. Recommend instead transferring the balance to the General Fund.

**Analysis****Page****Department of Personnel Administration**

- F-79     ■     **No Need for Consultants to Study Personnel Reform Again. Reduce Item 8380-001-0001 by \$1 Million.** Recommend rejecting the administration's request for \$1 million from the General Fund to pay consultants to develop a plan for reforming the state employee classification system. If the administration wants to implement such civil service reform, it should propose a comprehensive plan to the Legislature instead of spending money to study piecemeal, incremental changes.
- F-80     ■     **One Exempt Employee Versus a Wave of Employee Retirements: An Ineffective Plan. Reduce Item 8380-001-0001 by \$140,000.** Recommend rejecting the department's request for \$140,000 from the General Fund to pay for a single exempt employee who would assist departments in implementing workforce and succession plans.
- F-81     ■     **Planning Is Insufficient for Proposed Web Site. Reduce Item 8380-001-0001 by \$100,000.** Recommend rejecting the joint Department of Personnel Administration and State Personnel Board General Fund request to improve the state's human resources Web sites. The project is not well developed, and required planning documents have not been submitted.

**California Horse Racing Board**

- F-83     ■     **Board Should Explore Other Options to Keep Drug Test Costs Down. Reduce Item 8550-001-0942 by \$851,000.** Recommend rejecting request for \$851,000 from the Racetrack Security Fund to expand the board's equine drug testing program. The board should explore other options to fulfill the Legislature's mandates on drug testing and avoid increasing state costs. This recommendation would increase General Fund resources by \$851,000.

---

**Analysis****Page****California Department of Food and Agriculture**

- F-86 ■ **Shorten Pilot Program for Vehicle Inspections.** Recommend shortening a proposed pilot program for private vehicle inspections. One year should be sufficient to reassess the pest risk from private vehicles.
- F-87 ■ **No New Funding Needed for Hydrogen Fuels Standards. Reduce Item 8570-001-0001 by \$174,000.** Reject request for General Fund support of \$174,000 to continue development of interim hydrogen fuel standards. Proposal does not account for a substantial carryover balance from the current year.

**Department of Finance**

- F-89 ■ **New Mandates Unit.** Withhold recommendation on \$537,000 and four positions, pending receipt of the department's mandate reform proposal.

**Commission on State Mandates**

- F-92 ■ **Mandate Backlog Uncertain.** Withhold Recommendation on Item 8885-299-0001, pending updated information regarding the size of the backlog from the State Controller's Office.
- F-93 ■ **Higher Cost for Mandates in the Budget Year.** We recommend the Legislature Increase Item 8885-295-0001(1) by \$54 million or Take Other Action to Reduce the Cost of These Ongoing Mandates.
- F-93 ■ **New Mandates May Cost Less.** We withhold recommendation on Item 8885-295-0001(2) pending information regarding when other new mandates may be adopted. We further recommend the Legislature enact legislation to clarify the date by which a new mandate must be identified for its funding to be included in the annual budget.
- F-94 ■ **Likely Current-Year Mandate Deficiency.** We recommend the Legislature take action to recognize an anticipated current-year mandate deficiency of \$140 million.

**Analysis****Page**

- F-94 ■ **Another Mounting Backlog of Claims.** We recommend the Legislature pay these claims in full in the 2006-07 budget or include them within the state's 15-year repayment plan. In future years, we recommend the Legislature pay these claims annually to avoid incurring another large backlog of mandate claims.
- F-95 ■ **Conform Funding Level for AB 3632 Mandate With Policy Decisions.** We recommend the Legislature conform its policy decisions regarding the AB 3632 program to the funding in this item. If the Legislature does not change these mandates into a categorical program—or if the new program does not begin on July 1, 2006—additional funding under this item may be needed.
- F-96 ■ **Provide More Information About Mandates in Budget.** We recommend that the Department of Finance submit a report on its plans to provide detailed mandate information in future Governor's budgets and budget bills.
- F-98 ■ **Workers' Compensation Cancer Presumption.** We recommend the Legislature request the commission to reconsider past decisions regarding local government workers' compensation costs.
- F-100 ■ **Newly Identified Mandate Review.** We recommend adoption of the Governor's proposal to fund the Postmortem Examination: Unidentified Bodies, Human Remains mandate because the legislation has provided information that is currently used by law enforcement personnel to identify missing persons.

**Department of Veterans Affairs and  
Veterans' Homes of California**

- F-102 ■ **Reject Salary Savings Exemption for Veterans' Homes. Reduce Item 8960-001-0001 by \$1,166,000; Item 8965-001-0001 by \$134,000; and Item 8966-001-0001 by \$428,000.** Recommend rejecting the salary savings exemption for the veterans' homes. The administration's proposal does not provide an adequate analysis of specific position problems and deviates from standard budgeting practices.

---

**Analysis****Page****Health and Dental Benefits for Annuitants**

- F-107 ■ **Budget-Year Costs Not Yet Completely Determined.** Withhold recommendation on the request for \$1 billion from the General Fund for annuitants' health and dental benefits pending final determination of the state's health and dental premium rates for calendar year 2007.

**Employee Compensation**

- F-110 ■ **Employee Pay and Benefit Increases—Item 9800.** The budget includes \$382 million (\$203 million General Fund) for compensation increases for: (1) memoranda of understanding (MOUs) with five of the state's 21 employee bargaining units, (2) supervisors and managers of employees in those five units, (3) judges, (4) prison medical personnel required to receive them by a court order in the *Plata v. Schwarzenegger* case, and (5) for medical personnel in other departments.
- F-113 ■ **Plata Lawsuit Compensation Increases. Reduce Item 9800-001-0001 by \$36,109,000. Reduce Item 9800-001-0494 by \$10,865,000.** Reduce the requested amount for required *Plata* compensation increases. Current estimates for compensation increases resulting from the *Plata* court order show that the required increases for prison medical staff total only \$21 million. Any other compensation should be handled in the collective bargaining process.
- F-115 ■ **Budget-Year Costs Not Known, but Probably Will Rise Above the Proposed Amount.** Withhold recommendation on the remainder of the funding request to augment employee compensation pending information on any new MOUs that the administration negotiates with state bargaining units. The budget—typical of recent practice—includes no funding for possible new MOUs. Funding for employee compensation, therefore, could exceed the amount in the budget proposal.

**Analysis****Page****Midyear Budget Reductions**

- F-118 ■ **Delete Midyear Budget Reduction Authority. Delete Control Sections 3.45, 4.05, and 4.06.** Recommend deleting control sections from the budget that allow the administration to make midyear reductions to appropriations. These types of sections rarely achieve the intended savings. The sections also undermine the Legislature's authority and priorities.

**Retirement Contributions**

- F-121 ■ **Retirement System's New Policy Should Reduce Rate Volatility.** In 2005, the California Public Employees' Retirement System (CalPERS) adopted a rate stabilization policy. We believe that the new policy promises more stability in contribution rates for the state and other public entities.
- F-124 ■ **Projected State Contribution Rates Down Slightly.** Withhold recommendation on 2006-07 contribution rates for retirement benefits pending final determination by the CalPERS board based on the system's annual actuarial valuation. Because of healthy investment returns, CalPERS projects that required state contribution rates will decline slightly in 2006-07.
- F-126 ■ **No Pension Obligation Bonds Are Assumed in Budget.** In November 2005, a court found that the legislation authorizing the sale of pension obligation bonds was unconstitutional. The Governor's budget assumes that no pension obligation bonds will be issued in the current or budget years.