2008-09 Analysis

Major Issues

General Government

Tribal Gambling Payments: Governor's Revenues Overstated, But Opportunities for Budget Solutions

- As we discuss in "Part III" of our companion publication *The 2008-09 Budget: Perspectives and Issues,* the Governor's budget assumes that tribal gambling compact payments to the General Fund will total $154 million in 2007-08 and $430 million in 2008-09. Even with the passage of Propositions 94, 95, 96, and 97, we conclude this estimate is overstated by $173 million over the two years combined. The administration makes overly aggressive assumptions about the growth in casinos' customer bases and slot machines.

- We recommend two ways that the Legislature can use existing tribal payments to help the General Fund. First, we recommend that the Legislature suspend, on a one-time basis, the use of $101 million in payments from the 2004 compacts for transportation loan repayments and instead direct the revenues to the General Fund. Second, we recommend that the Special Distribution Fund—which has a projected fund balance of $197 million—make $40 million in payments to non-compact tribes, rather than the General Fund (see page F-44).

No Pay Raise for Correctional Officers At the Present Time

- The administration proposes a 5 percent raise for correctional officers (retroactive to July 1, 2007) and legislation to allow it to impose a labor settlement on the officers' union. In our recent report *Correctional Officer Pay, Benefits, and Labor Relations*, we find that the officers' compensation levels are sufficient to allow the prisons to meet personnel needs at the

present time. We therefore recommend that the Legislature not increase compensation in 2007-08. Such an approach would reduce General Fund costs by $491 million in 2007-08 and 2008-09 combined, compared to the Governor's budget (see page F-130).

New Statewide Financial Computer System: Increase Legislative Oversight and Reduce Debt Financing

- The Governor proposes to issue $1.2 billion in bonds over the next ten years to fund implementation of a $1.6 billion computer system to modernize the state's accounting and budgeting, known as Financial Information System for California (FI$Cal). We recommend an alternative approach which limits the initial scope of the project, allows for extensive legislative review before proceeding with statewide implantation, results in lower initial expenditures, and reduces the project's reliance on borrowing (see page F-91).

Closing the Tax Gap Can Yield More Revenues

- The Governor proposes $44 million in General Fund augmentations for the Board of Equalization (BOE) and Franchise Tax Board (FTB) to improve tax collections and help close the "tax gap." These efforts would raise an estimate $151 million in the budget year. We recommend the Legislature shift resources away from BOE proposals with low revenue benefits per dollar spent and instead direct funds towards FTB efforts with much higher returns. We recommend spending slightly less than the administration—yet with the benefit of tens of millions of additional dollars in General Fund revenues (see page F-55 and page F-60).

Infrastructure Bank Loans Do Not Target Economic Development

- The Infrastructure and Economic Development Bank (I-Bank) provides low cost loans to local governments for infrastructure projects that are supposed to promote economic development and improve land use. However, loans made by the I-Bank do not effectively meet these objectives. In fact, two-thirds of all projects that received loan funds provided no economic development benefits by the I-Bank's own measures (see page F-23).

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OVERVIEW

General Government

Total state funding for general government is proposed to increase by almost 4 percent in the budget year. This increase is the net amount from a number of factors, including both one-time costs and savings in 2007-08, various budget savings proposals for 2008-09, and some rising expenditures.

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 *2008-09 Governor's Budget* proposes $8.4 billion in state expenditures (combined General Fund and special funds) for these functions. The proposed budget-year funding is $295 million (3.6 percent) more than proposed 2007-08 expenditures.

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 and retirement, which includes increased salary and benefit costs for current and former employees.

We describe these program areas below, and Figure 1 (see next page) shows the proposed 2007-08 and 2008-09 expenditures by program area.

Figure 1

General Government Spending by Program Area

(Dollars in Millions)

Program	Proposed 2007-08	Proposed 2008-09	Difference	
			Amount	Percent
State administration	$3,972	$4,061	$90	2.3%
Tax relief/local governments	1,010	1,114	104	10.3
State employee compensation/retirement[a]	3,153	3,254	101	3.2
Totals	**$8,135**	**$8,430**	**$295**	**3.6%**

[a] Costs not reflected in departments' budgets, such as payments for retirees' health premiums.
Detail may not total 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.

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 most cases, the Governor's budget proposes to reduce these services as part of the administration's across-the-board reductions. After accounting for some increasing costs, there is a slight decrease in funding for these departments compared to the amounts received in 2007-08.

Regulatory Activities. Many departments are responsible for providing regulatory oversight of various consumer and business activities. These agencies 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.

Tax Collection. The Franchise Tax Board (FTB) and the Board of Equalization (BOE) are the state's two major revenue collection agencies. The 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 $875 million ($796 million General Fund) for these two agencies in 2008-09, up $45 million (5 percent) from the current year. This increase is due principally to proposed augmentations to increase tax enforcement and collection activities. These augmentations are expected to increase General Fund revenues by about $150 million in 2008-09.

Services to Other Departments. Some state departments exist primarily to provide support for other departments. For instance, the Department of General Services assists state departments on purchasing and real estate decisions. The Department of Finance acts as the state's fiscal oversight agency. The administration proposes $40 million for additional development costs of the $1.6 billion Financial Information System for California (FI$Cal), a computer project intended to modernize the state's budgeting and accounting systems. This proposal is reflected in a new budget item, Item 8880. The administration proposes to finance most of the project's costs.

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 reimburses local governments for state-mandated costs. The Governor's budget proposes to increase payments in this area from $1 billion to $1.1 billion. This reflects an increase in mandate payments due to the state's prepayment of 2007-08 costs to retire its mandate backlog. Partially offsetting this increase are budgetary savings proposals to (1) delay $75 million in 2008-09 mandate payments and (2) reduce most tax relief programs by 10 percent.

State Employee Compensation and Retirement Programs

State Employee Compensation. The costs for compensating about 350,000 state government and university employees under existing pay and benefit schedules are included in each department's budget. The Governor's budget assumes that employee salaries total $23 billion (all funds) in 2008-09. Including employer benefit expenses (principally retirement and health benefit contributions) and payroll taxes, the total cost of compensating these employees is about $30 billion. The Governor also proposes $615 million ($362 million General Fund) in the budget item that covers

the costs of anticipated and proposed pay and benefit increases across all departments. Most of the General Fund amount consists of the estimated costs to impose the administration's contract offer on the correctional officers' union. Under the administration's plan, the $230 million included for this purpose assumes that the Legislature also approves proposals to reduce the state's prison population, thereby reducing personnel costs. Also included in the budget item are initial estimates of costs to provide pay and benefit increases to California Highway Patrol officers (whose current labor agreement expires in 2010) and professional engineers. The engineers' current labor agreement expires on July 2, 2008, but includes a final pay increase effective on the first day of the 2008-09 fiscal year. The state's 19 other labor agreements with employee bargaining units already have expired or will expire on June 30, 2008. In general, the Governor's budget includes no funds to increase pay and benefits for members of these 19 units or their supervisors and managers. Accordingly, if the Legislature approves any new labor agreements, additional 2008-09 costs will have to be paid from the reserve.

Retirement Programs. The state contributes to the retirement benefits of:

- State and California State University employees—through the California Public Employees' Retirement System (CalPERS).
- School and community college district teachers and administrators—through the California State Teachers' Retirement System (CalSTRS).
- Judges and other small groups of employees.

As shown in Figure 2, General Fund costs for these retirement programs (excluding payroll taxes for employees' Social Security and Medicare benefits) spiked upward to $4.8 billion in the current year—an increase of 23 percent—due largely to a one-time, court-ordered payment to CalSTRS of $500 million described below. The Governor's budget assumes that General Fund retirement costs total $4.6 billion in 2008-09. As shown in Figure 2, the state's contributions to CalPERS' retirement programs increased sharply in the early part of this decade due largely to declines in the stock market, which affected the investment portfolios of CalPERS' pension funds. These contributions have stabilized recently due to (1) large recent years' gains in the CalPERS' investment portfolio, (2) CalPERS' implementation of a policy to stabilize employer contribution rates, and (3) the stable benefit levels for current or past employees. Since 2004, the most consistent driver of increased retirement contributions (not including the costs related to the CalSTRS lawsuit) has been the state's retiree health program. The Governor's budget assumes that 2008-09 will be the eleventh consecutive year of double-digit percentage growth in retiree health expenses. This rapid growth is caused by (1) increases in health

premium costs established by CalPERS and (2) growth in the number of state retirees. Because the state pays retiree health costs on a "pay-as-you-go" basis (unlike pensions), there are no investment returns generated to cover a portion of these expenses.

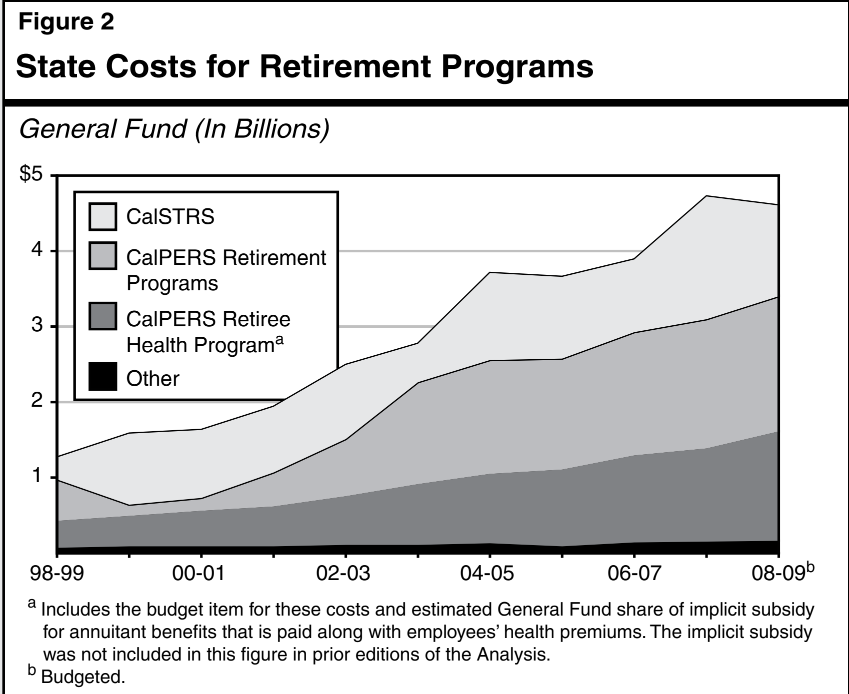


Figure 2

State Costs for Retirement Programs

[a] Includes the budget item for these costs and estimated General Fund share of implicit subsidy for annuitant benefits that is paid along with employees' health premiums. The implicit subsidy was not included in this figure in prior editions of the Analysis.

[b] Budgeted.

CalSTRS Proposals. The Governor's budget includes several proposals concerning CalSTRS. The state lost a court case in 2007-08 concerning a one-time reduction of payments to CalSTRS four years ago, and the court required the state to pay an unbudgeted $500 million to the system during the current year (pursuant to a continuous appropriation). The administration proposes that the Legislature appropriate funds over a three-year period (beginning with an $80 million payment in 2008-09) to comply with payment orders of the court related to interest and legal costs. In addition, the administration proposes changing the inflation protection component of CalSTRS benefits to reduce current-law expenditures by $80 million in 2008-09.

CROSSCUTTING ISSUES

General Government

VACANT POSITIONS

Statewide Vacancy Rate Consistently Has Been About 14 Percent

According to State Controller's Office (SCO) records, about 14 percent of authorized full-time equivalent employee positions are vacant in the executive branch—excluding positions in the university systems. Our review of SCO records shows that statewide vacancies in recent years have been consistently at about this level and vacancy rates vary substantially between departments. State departments will always have some level of vacancies, but vacancies at this high a level are considerably greater than assumed during the budget process.

Substantial Numbers of Authorized Positions Are Consistently Vacant. In our *Analysis of the 2003-04 Budget Bill* (see page F-19), we discussed some of the past efforts to address vacancies in authorized employee positions in state departments. Despite multiple efforts by the Legislature to reduce the number of vacancies, SCO data and other reports indicate that they remain widespread across state government. As of the end of September 2007, SCO records indicate that 14 percent of authorized full-time equivalent executive branch positions were vacant (not including positions in the university systems). We have monitored this statistic on a regular basis since 2006, and the statewide vacancy rate has been about 13 percent or 14 percent at the end of each calendar quarter. The vacancy rate, however, varies significantly by department, as shown in Figure 1 (see next page). As we discuss below, there are several reasons for the wide variations in departments' vacancy rates.

Figure 1

Vacancy Rates Vary Substantially by Department[a]

Mental Health	28%
Corrections and Rehabilitation (Juvenile Justice)	23
Child Support Services	21
Health Services	19
Public Health	17
Fish and Game	14
Statewide Average	**14**
Veterans Affairs	14
Corrections and Rehabilitation (Adult)	14
Social Services	13
Franchise Tax Board	11
California Highway Patrol	10
Motor Vehicles	9

[a] Compiled from State Controller's Office established and vacant positions statewide database as of Sept. 28, 2007.

Budget Process Is Premised on a Lower Level of Vacancies. Vacancies in authorized employee positions are a normal part of human resources management in both the public and private sectors. When employees move to other jobs or retire, it takes time to fill their positions, and when new positions are authorized, it takes time to fill them as well. Since 1943, the state budget has included provisions for "salary savings" to account for the fact that departments cannot fill 100 percent of their positions all of the time. When a department requests funding for new positions in a budget change proposal, its request for funds to cover salaries and related costs generally is reduced by 5 percent. (There are some exceptions to this rule, such as budgets for correctional officers' salaries, which generally include no assumed salary savings.) In subsequent years, augmentations to departments to cover the increasing costs of employee salaries also generally are reduced to take account of the 5 percent salary savings factor. In short, the state budget process assumes that around 5 percent of authorized positions will be vacant at any given time during the year due to normal turnover and hiring delays. The current level of position vacancies across the executive branch—14 percent—is much higher than the assumed 5 percent level.

What Level of Vacancies Is Reasonable to Expect? Individual circumstances of departments affect the number of departmental position vacancies at any given time. Control Section 4.11 of the annual budget act requires that all new positions approved in the budget be established effective July 1 (the first day of the fiscal year), unless otherwise approved by the Department of Finance. Accordingly, in fiscal years when the Legislature authorizes significant expansions in the number of authorized personnel in a department, it is reasonable to assume that departments will need some time to fill those positions. Therefore, vacancy rates will increase temporarily in line with the authorized staffing increase. (In some cases, the budget takes account of this fact, assuming a higher-than-usual level of salary savings during the initial year of an authorized staffing increase.) Vacancy rates also can rise when departments have an unusually large number of employees retiring at the same time. As more and more "baby boomers" reach the average age of state employee retirements (around age 60 for members of the California Public Employees' Retirement System, excluding peace officers), some departments may experience elevated vacancy rates. Finally, as discussed below, tough budget years can increase vacancies as departments seek ways to reach budget savings targets. During typical periods, however, we think it is reasonable to assume that most departments should be able to keep all but 5 percent to 10 percent of their authorized positions filled at any given time.

Salary Levels Often Are *Not* the Main Reason For High Vacancy Rates

Compensation levels sometimes are one factor that makes it difficult for departments to fill positions. Our experience, however, is that **other** ***factors often are*** **much more significant** ***in driving high vacancy levels. These factors include: (1) antiquated and inefficient hiring processes throughout the state's civil service system, (2) departments' usage of budgeted personnel funds to support other expenses that have not been accurately accounted for during the budget process, and (3) departmental responses to cost reduction measures enacted during tough budget years.***

Causes of Vacancies Vary by Department and Can Be Difficult to Evaluate. Employee groups often attribute high vacancy rates to state salaries being lower than those for comparable jobs. In response to legislative inquiries, we have examined several departments with major vacancy problems in recent years. The reasons for departmental vacancies vary considerably from department to department, and these reasons often are complex to evaluate and understand. In some cases, uncompetitive state employee compensation levels may be one of several contributing factors to employee vacancies. In most cases, however, we have found that state salary levels are not the main cause of high vacancy rates.

Antiquated, Inefficient Civil Service Hiring Processes Are One Cause. In our experience, departments with high vacancies tend to be ones with other systemic problems affecting their hiring processes. Throughout state government, civil service hiring processes take many months to fill a vacant position. The sheer length and complexity of the civil service hiring process creates a large burden not just for applicants but also for departments seeking to keep positions filled. In some cases, human resources (HR) functions—staffing levels of HR personnel, HR technology resources, training budgets, and resources available to conduct criminal and health background checks—have been kept lean through difficult budget years, resulting in departments having limited capabilities to hire and train personnel quickly and efficiently. In May 2007, for example, we reported to the Legislature that the 14 percent vacancy rate among warden positions in the Department of Fish and Game appeared largely attributable to systemic problems in the department's hiring process.

Use of Budgeted Personnel Funds for Other Purposes Is One Cause. In some cases, departments use budgeted personnel funds in one program to (1) keep positions filled or pay other unbudgeted expenses in another program or (2) cover expenses within the same program that end up being more than budgeted. For example, a 2002 Bureau of State Audits (BSA) report found that the majority of savings from vacant positions in five departments was used to cover higher-than-budgeted costs for filled positions.

Tough Budget Years Can Lead to Higher Vacancies. A tight fiscal situation—especially if it persists over several years—contributes to higher vacancy rates. During these times, state budgets often include actions such as elimination of price increases for operating expenses and across-the-board reductions to state operations costs. In response, departments often are forced to intentionally hold positions open or otherwise achieve salary savings above the 5 percent budgeted level in order to stay within their budgets. For example, the Office of the State Public Defender—acting in reaction to the Governor's budget plans due to the fiscal emergency—held open six budgeted attorney positions in late 2007 despite having qualified applicants to fill the slots. By doing this, the office sought to minimize the need to lay off either these new hires or current employees. Consequently, the department reduced its ability to process new appellate death penalty cases. Should the Legislature move forward with the Governor's proposed across-the-board budget cuts for 2008-09, we expect that vacancy rates will climb as other departments hold positions open in order to minimize layoffs and mitigate other programmatic impacts.

Recommend Repealing Ineffective Law on Abolishing Vacant Positions

An existing state law purports to abolish positions that are vacant for six consecutive months. The law, however, eliminates only a small number of vacant positions and generates significant paperwork in order for departments either to (1) correct SCO vacant position records or (2) claim one of the many specified exemptions in the law and avoid the abolition of positions. The law does not reduce departments' budgets for the small number of vacant positions eliminated. Due to its ineffectiveness, we recommend the law be repealed.

Government Code Abolishes Certain Vacant Positions. Amended several times in budget trailer bills in recent years, Section 12439 of the Government Code requires SCO to abolish certain authorized positions in departments that are vacant for six consecutive months. Departments are prohibited from executing any personnel transactions for the purpose of circumventing the provisions of the law. The law, however, contains 14 categories of exemptions—in other words, reasons that a department can cite for avoiding the abolition of positions, even though they may have been vacant for six consecutive months. Figure 2 (see next page) lists these 14 exemption categories. While the law requires SCO to abolish vacant positions, it contains no provision to reduce departments' budgets in conjunction with these actions. In order for such reductions to take place, the Legislature would need to specifically reduce each department's budget in the annual budget act.

In 2006-07, the Law Eliminated Only About One of Every 63 Vacant Positions. During 2006-07, the law resulted in the abolition of just 452 authorized positions. This constituted about one of every 63 vacant positions. The law resulted in the abolition of a higher number of vacant positions—1,958—during 2005-06, about one of every 14 positions that were vacant as of the end of that fiscal year. We believe that the wide variety of exemptions in the law, as well as an undetermined amount of departmental actions to evade its requirements, are the likely reasons for so few positions being eliminated.

Recommend Repealing the Law. We conclude that this law is ineffective and provides only the appearance of a solution to the widespread vacancy problem. Moreover, the law does not result in budgetary savings. For these reasons, we recommend that the law be repealed.

Figure 2

Exemptions From Abolishing Vacant Positions Under Current Law

Government Code Section 12439 provides for abolishing positions that have been vacant for six consecutive months. The law, however, provides for exemptions for positions:

- That were vacant during a period when a hiring freeze was in effect.
- That the department has diligently attempted to fill.
- Designated as managerial in nature and held vacant pending appointment of a departmental executive.
- In a classification that is determined to be hard to fill.
- Held open due to late enactment of the budget.
- Necessary for providing 24-hour care in a state institution.
- Necessary to satisfy local, state, or federal licensure or regulatory requirements.
- Directly involved in services for public health, public safety, or homeland security.
- Held vacant because a previous incumbent is eligible to exercise a right of return from a leave of absence.
- Held vacant because a previous incumbent has been granted a permissive leave of absence authorized under law.
- That, if eliminated, would directly reduce state revenues by more than would be saved by their elimination.
- That directly respond to unforeseen agricultural circumstances and are funded under a specific section of state law.
- That are exempt from the civil service.
- For the California State University that are instructional or instruction-related.

Options for the Legislature to Address Vacant Positions

Departments should be held accountable when they do not fill positions that were authorized and funded by the Legislature. In developing a new process for this purpose, the Legislature has several options. In our view, an effective accountability process probably would be labor-intensive for the Legislature, the administration, or other state entities.

Members of the Legislature have repeatedly expressed concerns about departmental vacancy problems. When the Legislature authorizes and

funds an employee position in the budget act, it does so with the expectation that a department will fill the position and provide the public services associated with it. When departments are unable to fill positions—particularly when their vacancy rates far exceed the assumed level of salary savings in their budget—this means that the Legislature's expectations are not being met. In our view, departments should be held accountable when this occurs. Accordingly, the Legislature should develop a process to allow for regular review of departments with significant vacancy problems. The Legislature has several options in this regard. As discussed above, we have found that the existing vacancy law is ineffective in addressing vacancy problems. A downside of the other options we discuss below is that they may prove to be labor-intensive for the Legislature, the administration, or other state entities. Each department's vacancy issues tend to be unique, making a uniform statewide solution difficult to implement effectively.

Regular Examination of Departments' Vacancies During the Annual Budget Process. During the annual budget process, the Legislature has the opportunity to question departmental officials on many aspects of state operations, including their success in filling authorized positions. One option for the Legislature is to make such reviews a more formulated part of the budget process. The Legislature could decide to undertake detailed reviews of vacant positions in a set number of departments each year—perhaps, rotating among departments so that they are the focus of this review during the budget process every few years. (The Legislature could start such detailed reviews by examining departments with the highest vacancy rates.) We believe that such reviews should involve questioning departments to understand the precise reasons for vacancies. In the nearby box (see next page), we list key questions that legislators may wish to ask departments when considering these issues.

Requesting Audits of Departments With Vacancy Problems. The Bureau of State Audits (BSA) previously has conducted several reviews of departments' vacant position problems. Given the Legislature's concern about these issues, it may wish to request that the Joint Legislative Audit Committee (JLAC) dedicate a portion of BSA's time and resources to reviewing vacancy issues in departments. These reviews could be managed in a number of ways, similar to the options discussed above. The committee could direct BSA to review vacancy issues in a set number of departments each year—rotating among major departments so that they are audited every few years. Alternatively, JLAC could periodically request that BSA review departments with the most significant vacancy problems. In our view, BSA's review of vacancy problems should consider the same sorts of issues discussed in the nearby box. In addition to JLAC's review of BSA's findings and recommendations about vacant positions, we also would

Suggested Questions for the Legislature To Ask Departments About Vacant Positions

When considering departments' vacant positions, the Legislature should first determine if the vacant positions are necessary to ensure delivery of high-priority public services. If the answer is "yes," the Legislature then might pose the following questions to departments:

- Are funds available to fill the vacant positions?
- Would filling the positions result in the need to divert resources from other programs? (If the Legislature determines that a diversion of resources from the other programs is an acceptable consequence of filling the high-priority positions, it could instruct the department to reduce funding for the lower-priority programs. Otherwise, additional appropriations to the department might be needed for the department to fill the positions.)
- Are improvements in the departments' hiring process needed to fill positions quickly and efficiently? What would these improvements cost?
- If the hiring process is working smoothly and positions still cannot be filled, are compensation levels adequate? Should the administration propose increases in compensation during discussions with employee unions?

If, on the other hand, the vacant positions are determined not to be of a high priority:

- Should the department's authority for the vacant, lower-priority positions be eliminated?
- If the Legislature eliminates departmental position authority, should the department's budgetary authority be reduced by a like amount? In considering this issue, the Legislature should ask departments how they are spending existing budgeted funds for the vacant positions. Would such a budgetary reduction affect the delivery of *other* high-priority public services?

suggest that the BSA's reports be considered by relevant policy and fiscal committees. If the Legislature pursued this approach, it may need to (1) scale back requests for BSA to review other matters and/or (2) increase BSA's budgeted resources.

Periodic Zero-Based Budgeting for Departments With Vacancy Problems. Another option for the Legislature to hold departments accountable for vacancy problems would be to initiate periodic, zero-based budgeting requirements for those departments. Typically, the departmental budgeting process begins with its preparation of a "workload budget": the estimated funding and personnel resource requirements for departments to provide the level of public services specified under current law in the next fiscal year. In general, the workload budget takes the current amount of departmental funding and expands it due to rising enrollment, caseload, and population, as well as inflation and any new statutory requirements for a program. (Offsets are made for one-time activities.) In this process, the workload budget basically assumes that the department received the "right amount" of funding to deliver services during the prior year. By contrast, a zero-based budget makes no such assumption. Instead, a zero-based budget builds a departmental budget from the ground up. Zero-based budgeting involves a fresh review of the personnel needed to perform every service within a department or a part of a department. This process could hold departments accountable for vacant positions by determining whether they are actually needed or not.

There are two major downsides to zero-based budgeting. First, the process is very labor-intensive—not just for departments that must administer the process, but also for the Legislature. The administration would have to prepare and the Legislature would need to review extensive amounts of paperwork likely to be generated from such a process to justify each category of departmental expense. Second, it is possible that zero-based budgeting for some departments with vacancy problems would reveal a need to appropriate more funding to departments so that positions can be filled and desired levels of public services can be delivered. This could lead to even more pressure on the state's already-strained budget. Given these concerns, we would suggest that any such zero-based review be done on a very targeted, selective basis.

LAO Bottom Line. The Legislature needs to have processes that can hold departments accountable for not filling authorized and funded positions. As noted above, there are a number of options for the Legislature to consider in this regard. Each of the options, however, entails considerable time and energy to implement.

Broad Legislative Efforts Needed to Simplify, Expedite State Hiring Processes

The administration has proposed its Human Resources Modernization (HR-MOD) Project to reduce the number of classifications in state government, simplify hiring processes, increase the use of Web-based

technology for hiring and personnel management across departments, and tie a larger amount of pay increases to objective evaluations of employees' performance on the job. We agree in broad terms with the goals of HR-MOD, but await more information from the administration on specific plans and outyear costs. We recommend that the Legislature consider broad, systemic civil service reforms like those envisioned by HR-MOD, which should help departments minimize vacancy problems in the future.

2007-08 Seed Money for Administration's Civil Service Reform Project. The *2007-08 Budget Act* includes $3 million for the Department of Personnel Administration (DPA) and the State Personnel Board to further develop their proposed civil service reform project, HR-MOD. The HR-MOD project attempts to address various systemic problems with the existing civil service system, particularly prolonged delays for departments to hire applicants. Another goal is to position the state to cope with the large number of expected baby boomer retirements from its workforce during the coming years. The initial blueprint for the project—which would require up to eight years to be fully implemented—envisions major changes in state hiring processes, the civil service classification system, employee evaluations, and processes for determining merit-based salary adjustments for state employees. Additional information on the status of the project and any additional funding requests to advance the project in 2008-09 are expected to be submitted to the Legislature in the coming months. Over the next decade, the overall costs of HR-MOD would be substantial—perhaps in the hundreds of millions of dollars over the period.

Broad, Systemic Civil Service Reform Is Needed. We await more information on the administration's specific plans for HR-MOD. Nevertheless, we agree with the administration's general goal of implementing major reforms to the civil service system. Such reforms should seek to tie compensation to employee performance to a greater degree and modernize state hiring processes—for example, by reducing the time it takes a department to hire an employee from months or even years (as it is now) to days. We recommend that the Legislature consider such broad, systemic civil service reforms in the coming years, in part due to the need to address departmental vacancy problems.

DEPARTMENTAL ISSUES

General Government

SECRETARY FOR BUSINESS, TRANSPORTATION AND HOUSING (0520)

The Secretary for Business, Transportation and Housing oversees 13 departments detailed in Figure 1 (see next page) 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.

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

The budget provides 65.5 positions and $23 million (including $7 million from the General Fund) for the secretary's operations in 2008-09. This represents a net increase of 6.6 positions and about $1 million (from special funds) over the estimated current-year expenditures, mainly to increase staff support for the I-Bank.

INFRASTRUCTURE STATE REVOLVING FUND PROGRAM

The Infrastructure State Revolving Fund (ISRF) program is one of two programs administered by I-Bank. The ISRF program provides loans for local infrastructure improvements. Currently, the program is supported by about eight staff.

Figure 1

Departments Under Business, Transportation and Housing Agency

Business and Regulatory Departments
Alcoholic Beverages Control Board
Department of Financial Institutions
Department of Corporations
Department of Real Estate
Office of Real Estate Appraisers
Managed Health Care
Office of Patient Advocate
Transportation Departments
Department of Transportation
California Highway Patrol
Department of Motor Vehicles
Office of Traffic Safety
Housing Departments
Department of Housing and Community Development
California Housing Finance Agency

Program Objectives. The purpose of the ISRF program is to provide financial assistance to local governmental entities for infrastructure projects such as roads, water systems, sewer systems, and other public facilities. More specifically, statute intends the program to fund projects that promote efficient land use and resource conservation while also providing economic development opportunities. Local governmental entities eligible for funding from the program include cities, counties, assessment districts, and redevelopment agencies.

The program provides loans to sponsors of eligible infrastructure projects at interest rate costs that are lower than financing that can otherwise be obtained from the private market. Specifically, loans are made at two-thirds of the market interest rate for an A-rated tax-exempt bond. This reduced interest rate lowers the cost of borrowing to local governments and can enable infrastructure investment to occur sooner or at greater levels than may otherwise happen.

Initial Funding Came From General Fund. In 1998-99 and 1999-00 the I-Bank received a total of about $200 million from the General Fund to start up the ISRF program. Of this amount, $180 million was for financial

assistance and program administration, and $20 million was set aside for infrastructure projects for the Imperial Irrigation District.

Revenue Bonds Used to Leverage Initial Appropriation. The I-Bank loaned out the initial $180 million in the first few years of the program. These loans will typically be repaid over a 30-year period. In order to continue to make loans, the I-Bank issued revenue bonds in 2004 and 2005 to obtain additional funds up-front instead of waiting to collect enough funds from loan repayments before making more loans. In turn, the bonds will be paid from the repayments of outstanding loans. As a result, the amount of bonds the I-Bank can issue for the program is limited by, among other things, the stream of loan repayments available for debt service. The I-Bank indicated that it is currently undertaking a review of its leveraging model to determine the maximum loan level that can be supported by the ISRF program. According to I-Bank staff, a preliminary review suggests that the initial $180 million can be leveraged between one to three times. This means that the program can provide a maximum amount of loans between $360 million and $540 million.

Program Has Provided $337 Million in Loans So Far. With funding from the initial appropriations, revenue bond proceeds, and various interest earnings and fee revenues the I-Bank has issued a total of $337 million in loans to date, providing funding for 81 projects throughout the state. Funded projects cover a broad range of infrastructure including upgrading water systems, improving roads, and constructing complete packages of infrastructure (including water, sewer, roads and utilities) for new development and redevelopment projects, among others.

New Loan Activity Likely to Remain at Lower Levels. Figure 2 (see next page) shows the loans made annually from 1999-00 through 2006-07. As shown in the figure, the amount of loans dropped after 2001-02 when the initial $180 million was loaned out. This slowdown reflects, at least in part, the limitation on the amount of revenue bonds the I-Bank can issue based on the repayment of outstanding loans. So far, the I-Bank has issued two series of bonds, at $50 million each, for a total of about $100 million.

Program staff indicate that about $20 million is still available for new loans from the last bond issuance and that the I-Bank will likely issue a third series of revenue bonds sometime in 2008-09 to provide an additional $50 million for loans. Based on the average length of time it has taken the I-Bank to loan out bond funds, we estimate that it would take two years or longer to loan out the entire $70 million. Given the average loan amount of between $3 million and $5 million, this would allow the I-Bank to make about eight to ten loans a year for the next two years—on par with the level of new loan activities in recent years.

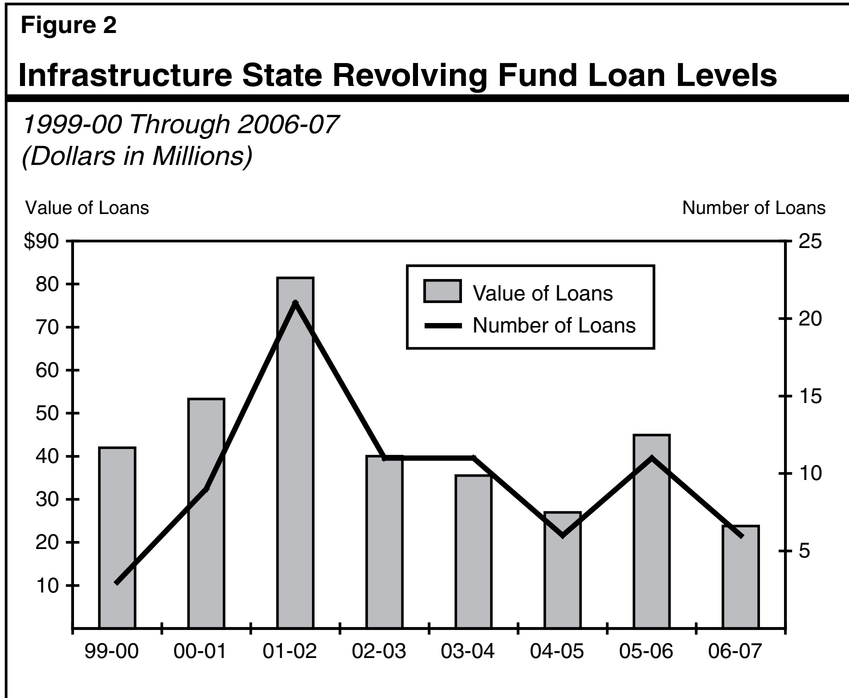


Figure 2

Infrastructure State Revolving Fund Loan Levels

1999-00 Through 2006-07
(Dollars in Millions)

Project Scoring Criteria Do Not Effectively Target Key Program Objectives

We recommend the enactment of legislation to provide further direction to the Infrastructure and Economic Development Bank on achieving the objectives of the Infrastructure State Revolving Fund program. This should include a provision to require projects to demonstrate economic development and land use benefits to be eligible for the program.

As mentioned previously, the purpose of the ISRF program is to provide infrastructure financing for projects that (1) provide for economic development, and (2) promote improved land use. While the ISRF program has helped local governments to make infrastructure improvements, our review shows that the program is not meeting statutory objectives and could better target limited state funds.

Economic Development and Improved Land Use Merit Increased Focus. To evaluate and rank potential projects for their eligibility for funding, the I-Bank uses 13 criteria and a project scoring system with a maximum 200 possible points as shown in Figure 3. A project must score at least 80 points to be eligible for an ISRF loan.

Figure 3

Infrastructure State Revolving Fund Program Project Scoring Criteria

	Maximum Points
Economic Development Impact	**50**
Job creation/retention	30
Economic base employers	10
Community economic development plan	10
Community Economic Need	**55**
Unemployment rate	20
Median family income	15
Change in labor force	10
Poverty rate	10
Land Use, Environmental Protection, and Housing	**40**
Land use	20
Environmental protection	10
Housing element	10
Others	**55**
Quality of life/community amenities	30
Leverage	15
Project readiness	10
Total Possible Points	**200**

Our review shows that the current scoring system does not effectively target funds to projects to provide economic development and promote better land use. Specifically, our review of approved ISRF loans indicates (1) the majority of projects that received loans have little or no economic development impact, and (2) projects do not need to have much impact on improving land use to receive loan funds.

- ***Many Projects Approved Despite Scoring Zero on Economic Development.*** As shown in Figure 3, the scoring criteria uses three measures of a project's economic development impact. Together, these measures account for one-quarter of the maximum possible score for a project. "Job creation/retention" measures a project's contribution to the development and retention of permanent jobs. "Economic base employers" assesses whether a project will benefit employers that bring revenues into the community from sales outside the region. Lastly, "community economic development plan" measures the cooperativeness of project sponsors with local economic and job development programs. Our review of

all 81 projects that received ISRF financing, however, shows that two-thirds of them scored zero points on all three measures.

- ***Land Use Objectives Receive Little Weight in Project Selection.*** Statute requires the I-Bank to consider the State Environmental Goals and Policy Report (SEGPR) in the development of project selection criteria for the ISRF program. The SEGPR sets forth statewide land use and environmental goals and suggests policies to achieve those goals. As Figure 3 shows, the weight of the land use criterion is worth a maximum of 20 points, or 10 percent of the total score. This weight does not appear to be large enough to ensure that projects that receive funding from the program will have any significant land use impact. It would be possible for a project to receive an ISRF loan even if it fails to achieve land use objectives. For instance, a project could score zero in the land use category and still receive an overall score high enough to qualify for a loan.

The ISRF program provides a service to local governments by assisting them in making infrastructure improvements at a lower cost than if financing is obtained from the private market. We think that the program can be made to better promote the state's economic development and land use objectives by targeting limited funds to those projects that demonstrate the desired benefits in their applications. Specifically, we recommend enactment of legislation to require that all ISRF-funded projects demonstrate at least a minimum level of economic development and land use benefits. For instance, projects could be required to achieve a portion, such as one-half, of their overall score from the economic development and land use criteria. Another approach would be to screen potential projects for economic development and land use benefits to ensure that only projects meeting the stated goals of the program are allowed to compete for funding.

Additional Staffing Not Justified on a Workload Basis

The budget requests four positions to augment staff for the Infrastructure State Revolving Fund program. Our review shows that two of these positions are not justified on a workload basis. Accordingly, we recommend rejecting two positions for a reduction of $219,000. (Reduce Item 0520-001-0649 by $219,000.)

The budget requests seven new positions for the I-Bank in 2008-09, including four positions to handle ISRF program workload. The four positions include two loan officers, an accounting position, and an office assistant. Our review of the program's workload shows that two of the requested positions are not justified on a workload basis.

- ***New Loan Activity Has Declined While Staffing Remained the Same.*** As discussed earlier, the program's new loan workload has not increased in recent years. In fact, as shown in Figure 2, the number and value of new loans issued by the ISRF program has declined since 2001-02. For instance, the I-Bank issued six loans worth $24 million in 2006-07 and thus far in 2007-08 it has approved four new loans worth $13.7 million. This level of activity is substantially lower when compared to 21 loans (worth $81 million) in 2001-02. However, the number of staff assigned to the program has remained at about the same level as it was in 2001-02.
- ***New Loan Activity Not Expected to Increase in 2008-09.*** As mentioned previously, the volume of new loans that the program will be able to make in 2008-09 is likely to remain at the lower levels seen in recent years. This expected level of new loan activity does not provide justification for an increase in staffing.
- ***Workload Associated With Existing Loans Has Increased.*** The workload to service and manage the portfolio of outstanding loans is handled in part by by accounting staff. For every approved loan, certain loan information must be entered into an accounting system, and repayments must be collected. Some of this accounting workload has increased, and appears to justify the addition of one accounting position. Other workload is performed by loan officers and is related mostly to the disbursement of funds. Disbursement workload does not appear to have increased and is relatively stable from year to year. This is because as new loans are approved and require disbursements, workload on older loans drops off as funds for them are fully disbursed. Additional disbursement workload will only increase by the extent to which new loans are made. In view of this stable workload, the request for an additional loan officer is not justified.

Accordingly, we recommend that the request for two loan officer positions be rejected, for a reduction of $219,000.

Reporting Inadequate to Facilitate Legislative Oversight

The Infrastructure and Economic Development Bank (I-Bank) is required to provide an annual report to the Legislature on its activities. The report, however, does not provide sufficient information to evaluate the performance of specific programs. We recommend that the I-Bank be directed to provide additional information necessary to facilitate legislative oversight.

Legislative Oversight Hampered by Limited Information. The I-Bank is required by statute to submit an annual report to the Legislature by November 1 of each year. The report currently provides a consolidated financial snapshot of the I-Bank as a whole, and provides some information on loan applications to the ISRF program. The report however does not provide financial information specific to the programs administered by the bank. Therefore, it is not possible to separately identify activities in the ISRF program; account for program and loan activities, workload levels, and program costs; or assess the program's performance in terms of the types and amounts of financial assistance applied for and subsequently granted. For instance, the level of funding provided for the ISRF program for loans and support cannot be determined from the annual report. Discussions with I-Bank staff have yielded some estimates of how much funding this program has received since its inception, but the use of these funds cannot be accounted for completely.

Additional ISRF Information Needed. To provide better information to facilitate legislative oversight of the I-Bank's activities, we recommend amending current law to expand the I-Bank's reporting requirement to include the following additional information in its annual report.

- The amount and source of main categories of revenues (such as interest earnings, fees collected, and bond proceeds) by program, specifically providing separate information for the ISRF program.
- The amount and type of major categories of expenditures (such as loans provided, debt service payments, and program support costs) by program, specifically providing separate information for the ISRF program.
- For the ISRF program, a summary of the number of preliminary applications that did not receive funding and the reason the sponsor or project did not qualify.

OFFICE OF PLANNING AND RESEARCH (0650)

The Office of Planning and Research (OPR) assists the Governor and the administration in planning, research, and policy development, and acts as a liaison with local government. The office has responsibilities pertaining to state planning and environmental and federal project review. The OPR also administers the California Volunteers program, the federal AmeriCorps and Citizen Corps programs, and the Cesar Chavez Day of Service and Learning grant program.

The Governor's budget proposes expenditures of $51 million ($9.5 million from the General Fund, $38 million in federal funds, and $3.5 million in reimbursements). As we discuss below, this includes a proposal to continue permanently $766,000 from the General Fund for the California Volunteer Matching Network (CVMN), which would otherwise expire in the current year. Also included are proposed General Fund reductions of $431,000 to state planning operational activities and $500,000 in local assistance grants for Cesar Chavez community service projects.

Volunteers Come at High Cost

We recommend that the Legislature reject the administration's proposal to continue $766,000 in General Fund spending for the California Volunteer Matching Network due to the duplicative nature of the program and the cost of the program per volunteer. (Reduce Item 0650-001-0001 by $766,000.)

Background. The CVMN was provided two-year, limited-term funding in the *2006-07 Budget Act* ($1.1 million annually from the General Fund) to launch a Web site, www.CaliforniaVolunteers.org, that pulls together local volunteering opportunities and posts them all in a single, state-centered database. The funding also provided assistance to existing walk-in volunteer "hubs," which serve 42 of the state's 58 counties. These hubs are operated by nonprofit organizations and help potential volunteers find volunteer opportunities.

Administration's Proposal. The administration requests $766,000 from the General Fund and 2.8 positions to permanently establish the CVMN. (The administration also proposes reducing this amount by $127,000 as a budget-balancing reduction.) The requested staff and resources would be used to continue the current marketing campaign for volunteering in California; maintain, improve, and expand the capabilities of the online database; and increase the number of and funding for local hubs.

Volunteers Come at High Cost. As we discuss below, the program duplicates other services available and has signed up few volunteers.

- ***Program Duplicates Available Services.*** There are many Web sites that provide potential volunteers the ability to search for opportunities in the state, including—www.VolunteerMatch.org, www.1800Volunteer.org, www.ServeNet.org, www.volunteer.gov, and www.HelpinDisaster.org (which recently coordinated volunteering activities related to the Southern California wildfires). There are many other Web sites that have a local focus or are organization specific. Additionally, the hubs that are linked together as part of the CVMN are run by nonprofit organizations and were independently operational long before the creation of the CVMN. As such, these resources would continue to function irrespective of the existence of the CVMN.
- ***High Cost Per Volunteer.*** Prospective volunteers that wish to sign up for an opportunity using the CVMN must first register with a hub. Nearly one year after the launch of the CVMN, local hubs had experienced a total increase of about 25,000 volunteer registrations. Among registrants, the number of potential volunteers that the CVMN actually referred to nonprofit organizations was about 9,000 in 2007—up from 6,000 annual local referrals prior to the launch of the CVMN. Given the $1.1 million budget for the program, the cost for each of the 3,000 new referrals was $380. While the cost per volunteer may decline somewhat in the future, it will remain a very expensive mechanism to sign up volunteers. The costs are even more dramatic when considering that many of the site's users would have found another avenue to volunteer in the absence of the site.

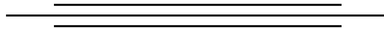
Recommend Rejecting Proposal. Given the availability of similar services from alternative sources and the significant costs associated with minimal increases in volunteer recruitment, the program has failed to justify its expenditures. Consequently, we recommend deleting the funding.

Suspend Discretionary Grants

Given the state's budget shortfall, we recommend suspending $5 million in General Fund grants for Cesar Chavez Day of Service and Learning community service projects. (Reduce Item 0650-001-0001 by $5 million.)

Background. The Cesar Chavez Day of Service and Learning program was authorized by Chapter 213, Statutes of 2000 (SB 984, Polanco). The program annually provides $5 million in local assistance grants to implement various service and learning activities for K-12 students related to labor leader Cesar Chavez. In the current year, approximately one-half of the funds were used to support after school clubs in middle schools throughout the state. The remaining funds were allocated to various community service projects across the state and for administration costs. The Governor's budget proposes reducing the grants by 10 percent in the budget year and provides $4.5 million in funding.

Recommend Suspending Funding. From 2003-04 through 2005-06, the grants were suspended by the Legislature due to the state's budget shortfalls. Given the state's fiscal situation, we recommend the Legislature once again suspend funding for the Cesar Chavez grant program. The program's annual appropriation is provided for in statute. The Legislature, therefore, would need to suspend the appropriation in a trailer bill. To increase future legislative flexibility, we recommend deleting this statutory appropriation and making future funding contingent on an annual budget act appropriation.



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 has administered criminal justice grant programs formerly managed by the Office of Criminal Justice Planning. Funding for the Office of Homeland Security is also included in the OES budget.

The Governor's budget proposes to spend approximately $1.5 billion in support of OES in 2008-09. Over $1 billion of this amount is from federal funds, primarily local assistance funding for disaster assistance and homeland security grants. The department's General Fund budget-year spending is proposed to decrease by 24 percent to $199 million, largely due to one-time 2007-08 expenditures associated with the 2007 Southern California wildfires and General Fund budget reductions of $21 million proposed in the budget year.

Restructure Local Assistance for Public Safety

Rather than impose across-the-board reductions on local assistance public safety programs, we instead recommend that the Legislature prioritize program reductions according to programs' objectives, sources of funding, and overall effectiveness. In the "Criminal Justice" chapter, we make various budget-year funding recommendations for OES's public safety programs.

As discussed in the "Crosscutting Issues" section of the "Criminal Justice" chapter, the state provides financial assistance to local governments for various public safety activities, including both law enforcement and programs focused on preventing crime and reducing recidivism. These local assistance programs are funded through different departmental budgets, including the California Department of Corrections and Reha-

bilitation, OES, and the Department of Justice. Other local assistance is provided through state sales tax revenue and through subvention programs administered by the State Controller. Under the Governor's budget plan, funding for local public safety programs administered by OES would total $71 million in 2007-08 and $65 million in 2008-09—reflecting the Governor's across-the-board approach to reducing each program's funding by roughly 10 percent. However, not all programs are the same. Programs differ in terms of objectives, sources of funding, and overall effectiveness. In the "Criminal Justice" chapter, we recommend that the Legislature prioritize program reductions and make specific funding recommendations for OES's public safety programs.

Decision on Fire Engines Tied to Surcharge Proposal

We withhold recommendation on a $10 million expansion of the Office of Emergency Services' wildland firefighting capacity pending the Legislature's key decisions on a new funding source for such costs.

Administration's Insurance Surcharge. In order to expand OES's firefighting capacity, the *2007-08 Budget Act* includes funding for 19 new fire engines. The department now has 119 engines. During the recent 2007 Southern California wildfires, the department used its own fire protection resources, and when necessary, utilized existing mutual aid agreements to draw on additional resources both from within and outside of the state. As we discuss in more detail in the "Department of Forestry and Fire Protection" writeup in the "Resources" chapter, the administration proposes to authorize a new surcharge on the insurance tax to cover wildland firefighting costs. Through the surcharge, the administration proposes to nearly double OES's fire protection budget and add 131 new fire engines over the next five years. The proposal would provide $10 million for OES fire protection in 2008-09. The funds would be used to purchase 26 fire engines and related equipment at a cost of $8.1 million. The remaining funds would be used to backfill existing General Fund resources that are proposed to be deleted as a budget balancing reduction.

Withhold Recommendation. As we discuss in the "Resources" chapter, we recommend that the Legislature adopt an alternative funding mechanism for wildland firefighting costs—a fee on state responsibility area property owners. We withhold recommendation on OES's request until the Legislature makes key decisions on a potential new funding source—including the funding mechanism, the amount to be raised, and the timing of implementation. Once those decisions are made, it will be easier to put OES's request in context of the state's overall firefighting approach.

DEPARTMENT OF INSURANCE
(0845)

In California, the Department of Insurance (DOI) is responsible for regulating insurance companies, brokers, and agents in order to protect businesses and consumers who purchase insurance. Currently, there are about 1,300 insurers and 268,000 brokers and agents operating in the state.

The budget proposes total expenditures of $224 million for DOI in 2008-09. This is $6 million, or 3 percent, more than estimated current-year expenditures. The Insurance Fund, which supports DOI operations, derives its revenues from regulatory assessments and fees. The budget proposes a staffing level of 1,272 positions for 2008-09, which is the same level provided in the current year.

Budget Provides No Staff for Collection of Special Assessment

The budget provides no funding or positions for collection of the proposed "special assessment" on commercial and residential fire insurance polices. Should the Legislature adopt the proposal, we recommend that it direct the department to report on the level of administrative resources required to implement the proposal. The department should also identify and report any potential issues related to the proposal's implementation.

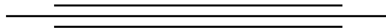
As part of the 2008 special session, the Governor proposed legislation to establish a "special purpose assessment"—equivalent to 1.25 percent of the premium—on commercial and residential fire insurance polices to support the firefighting activities of the Office of Emergency Services, Department of Forestry and Fire Protection, and the Military Department. The budget proposes to use the assessment revenues both to offset General Fund reductions (in two of these departments) and to expand program activity (in all three of these departments). The assessment, which the administration estimates would generate approximately $125 million in

2008-09, would be collected by DOI and deposited into a newly established Firefighting Safety Account within the Insurance Fund.

We have raised a number of concerns with the proposal, most notably that it essentially levies a surcharge on all residents of the state—including parties that do not directly benefit from the state's wildland fire protection efforts. As an alternative to the Governor's proposal, we have recommended that the Legislature consider enactment of a fire protection fee on property owners in State Responsibility Areas since they are the direct beneficiaries of these firefighting services. (For more discussion of our recommended alternative, please see our "Department of Forestry and Fire Protection" write-up in the "Resources" chapter.)

No Funds Provided to Carry Out Proposal. The Governor's budget does not provide any staff resources to DOI for collection of the special assessment revenues. The department has indicated that it would likely require some additional staff to implement the proposal. The level of staff resources required would largely depend on the process for collecting the funds. Although the administration's proposal calls for a quarterly collections process, at the time this analysis was prepared, the department was uncertain about other details of the collections process. Details such as whether payments by insurers would need to be reconciled with future premium collections could affect the level of staffing required. Without more program specifics, the department could not provide information on how much funding and positions would be required in 2008-09 to implement the proposal.

Should the Legislature adopt the Governor's proposal, we recommend that it direct the department to report at budget hearings on the funding and positions required, as well as on any other potential issues related to implementation of the proposed special assessment.



California State Lottery Commission (0850)

With approval of Proposition 37 at the 1984 general election, voters amended the State Constitution to authorize the creation of the California Lottery. Proposition 37 also established the California State Lottery Commission, which has broad powers to oversee the lottery's operations and fund distributions. While lottery operations are subject to oversight hearings by policy committees, lottery funds are not appropriated in the annual budget act.

The law requires that at least 34 percent of all lottery revenues, unclaimed prizes, and interest be distributed as supplemental funding to public educational institutions. Approximately 50 percent of revenues is distributed as prizes, and no more than 16 percent of revenues goes toward operating expenses, including compensation of participating retailers. With revenues of $3.3 billion in 2006-07, the lottery distributed $1.2 billion to public schools, community colleges, and universities. Lottery funds total less than 2 percent of all K-12 revenues.

Sales declined 7.4 percent between 2005-06 and 2006-07. Lagging consumer interest in several games, including the multistate MEGA Millions game, SuperLOTTO Plus, and instant ticket games, were responsible for the decline. Such declines have occurred periodically during the lottery's first two decades, including sharp drops during the late 1980s and early 1990s. Since 1997-98, however, lottery distributions to education have grown an average of 4.2 percent per year. At its June 2007 meeting, the Lottery Commission approved a 2007-08 budget that assumes lottery sales of $3.4 billion, an increase of about 1 percent over the prior year. The *2008-09 Governor's Budget* assumes that the Lottery meets this sales forecast in 2007-08, and, consistent with prior budgeting practices, assumes no growth in sales in 2008-09. Under the forecast, lottery distributions to education—$1.2 billion in 2006-07—would remain flat through 2008-09.

Legislative Considerations Regarding Changes to the Lottery

Noting Weak Lottery Sales, Governor Proposes Leasing It to Private Entity

The Governor has proposed leasing the California Lottery to a private concessionaire to improve its sales and generate funds for public purposes. This would require major changes to statutory restrictions on the lottery and, likely, approval by voters. A lottery transaction would generate a large up-front payment for the state under the Governor's proposal, as well as under other scenarios that do not involve leasing lottery management to private entities.

Lottery Sales Per Capita Are Low Compared to National Averages. The underlying issue framing recent policy discussions about the lottery has been its low sales per capita relative to other states. Figure 1 shows that in 2005-06, lottery sales per capita in California were about one-half of the national average. The administration seeks changes in lottery operations that it believes would lead to lottery sales increasing to a level closer

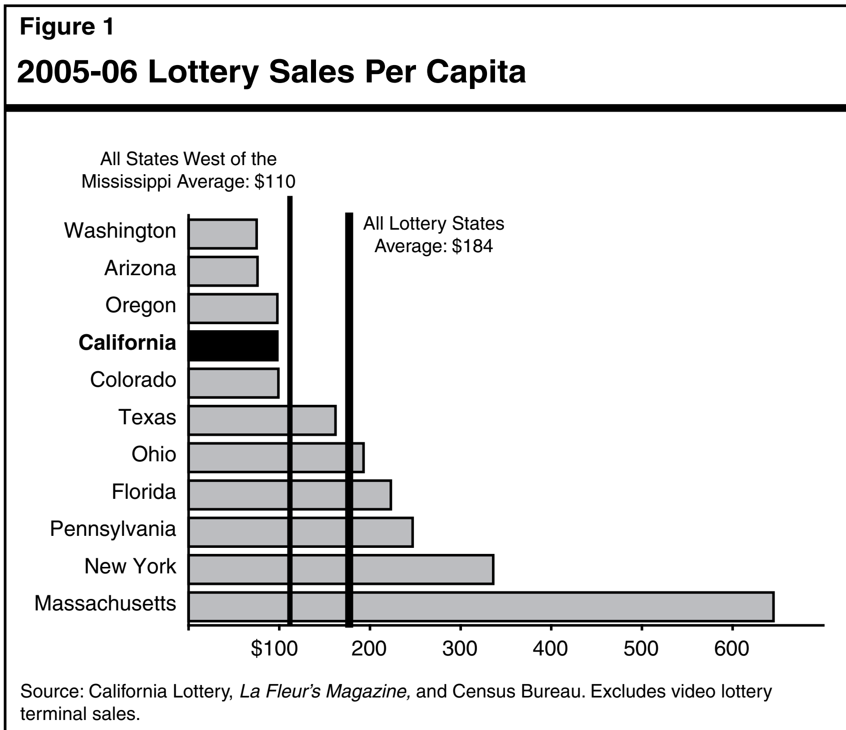


Figure 1

2005-06 Lottery Sales Per Capita

Source: California Lottery, *La Fleur's Magazine,* and Census Bureau. Excludes video lottery terminal sales.

to the national average. This would entail roughly a doubling of annual sales by the California Lottery and would increase per capita sales here far above the level currently reported for all states west of the Mississippi River. There is a long history of western states' lotteries generating less money than lotteries in some eastern states.

Governor's Proposals. In the 2007 May Revision, the Governor requested that the Legislature authorize the lease of operating rights for the lottery to a private concessionaire for a multidecade period—perhaps for 40 years. In October, the Governor proposed a lottery lease to instead help finance his health care proposal. The proposal is a general framework—similar to those proposed, but not yet adopted, in several other states—rather than a detailed implementation plan. Generally, the proposal assumes that the private sector would be more skilled than Lottery Commission staff in increasing visibility and sales for lottery games. In exchange for the lease to the private entity, the state would receive a one-time payment under the Governor's plan and/or annual payments from the private entity. While the Governor subsequently withdrew the lottery from his health care proposal, administration officials have indicated their continuing interest in pursuing a lottery lease.

Freeing Up Restrictions on the Lottery Would Be Required. While not spelled out in detail in the Governor's framework, it is generally acknowledged that the administration's plan would require significant loosening of some statutory restrictions concerning lottery operations. For example, the percentage of lottery sales paid out in prizes would need to be loosened. Several other states with higher per capita sales pay out a *higher* percentage of lottery revenues in prizes, and some states that have experimented with increasing prize payout percentages have found that this increases overall lottery profits. (In fact, the California Lottery has used administrative savings to boost Scratcher game payouts, with some success in increasing sales.) Many other technical changes to statutes may also need to be considered to maximize the value to the state from a lottery lease. Because the Lottery Act was implemented as a voter initiative, substantial statutory changes such as these would likely require voter approval.

Issuing Lottery Revenue Bonds—With No Lottery Lease—Is Also An Option. While no other state has yet leased or sold its lottery to a private entity, Florida, Oregon, and West Virginia have issued state revenue bonds—often for capital projects, such as school and university buildings—backed by future lottery sales. In these states, the lottery remains under public ownership and management. Subject to the bonds being legally authorized, however, bond proceeds theoretically could be used for many other purposes, including financing health care or other policy initiatives,

retiring state debt, decreasing unfunded retirement liabilities, cash flow relief, or budget relief.

A $37 Billion Up-Front Payment to the State Is Unlikely

The administration has estimated that a lottery transaction could generate up to $37 billion in up-front proceeds for the state. This estimate is unrealistic. The most such a transaction could generate would probably be one-half that amount or less. Such a transaction would mean that some or all lottery profits would no longer be allocated to educational institutions. The resulting decline in education funding could result in new budgetary pressures for the General Fund.

More Realistic Scenarios Envision a Much Smaller Up-Front Payment. The administration has suggested that leasing the lottery could generate up to $37 billion in upfront proceeds to the state. A lottery lease of the type proposed by the Governor would be unprecedented in the U.S. It is unknown what investors would pay for the right to operate a state lottery over 40 years. This amount could vary substantially depending on the "strings attached" to the deal by the Legislature and voters. Investors seeking to start a company to operate the California Lottery would need capital—as well as assurances that they could earn a positive return for their investment of the capital. Our research indicates that investors may finance a significant part of a required up-front payment to the state through issuing debt. Debt investors would require assurances that the company's share of lottery profits would be more than sufficient to cover its debt service costs. In order for debt investors to provide a substantial share of a $37 billion or similar up-front payment, they would have to count on dramatic increases in California Lottery sales—essentially, a doubling of per capita sales to levels far above the western states' average and levels near the national average. Given the recent tumult in the bond markets related to the subprime mortgage crisis—which has resulted in tightening of credit standards—this means that a $37 billion up-front payment is very unlikely to be available to the state, either through a lottery lease or a lottery revenue bond transaction. We believe that a more likely amount available in an up-front payment would be between $10 billion and $20 billion.

Holding Education Harmless Might Require Most or All of Up-Front Payment. Regardless of the up-front amount that could be raised from a lease of the Lottery, the Legislature would have to consider whether those proceeds would first be used to replace the loss of the annual stream of funding allocated to educational entities (currently about $1.2 billion). For example, some will argue that education should be held harmless relative to their current allocations. One way to accomplish this would be to use

the up-front payment to establish a large endowment that would generate investment returns and distribute to educational institutions roughly what they would have received from the Lottery under current law for the duration of the lease. The problem is that establishing such an endowment would require using most or *all* of the up-front payment for this purpose, and this would leave little available for other state purposes—perhaps defeating the purpose of undertaking the transaction in the first place. If, however, the Legislature and voters pursue a large up-front payment from a Lottery transaction, but opt *not* to establish such an endowment (instead using the up-front proceeds for budget relief or some other purpose), then the Legislature would face the following difficult choices in the future: (1) identifying new revenues or cutting other General Fund expenditures in order to hold education harmless or (2) deciding not to hold education harmless and thereby reduce the funding that schools, community colleges, and public universities would have received under current law.

Leasing the Lottery Would Take Some Time. If the Legislature and voters chose to pursue the Governor's proposal to lease the lottery, completing such a transaction could take several years. Voter approval may be required, and developing, refining, and finalizing requests for complicated proposals from the private sector could take months or years. Finally, legal challenges, such as from the state's other gambling interests, to such a sale are possible. Accordingly, if the Legislature wishes to pursue a lottery transaction, it should adopt a realistic timetable for receipt of any up-front proceeds.

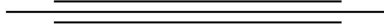
Recommend Considering Strategies to Improve the Lottery's Performance

The administration appropriately has raised the issue of whether the California Lottery is an underperforming state asset. We recommend that the Legislature continue to explore methods to improve the performance of the Lottery.

Time to Reexamine How the Lottery Works. The basic structure of the California Lottery has been in place for over two decades. We agree with the administration that it is time to examine how this structure and the lottery's overall sales performance could be improved. We doubt that per capita sales will increase to the national average in the foreseeable future, but there is evidence that California's lottery may be underperforming relative to other states.

Legislature Should Continue to Examine Possible Changes. The Legislature should continue to explore possible methods to improve the performance of the Lottery. In committee hearings, regular updates from Lottery management on developments resulting from its recently updated

business plan may be helpful. The Legislature also may wish to explore statutory changes—generally, changes to give Lottery management more flexibility to manage funds and increase prizes—that could increase the amount of funds generated by the Lottery for public purposes.



California Gambling Control Commission (0855)

The California Gambling Control Commission (CGCC) is the primary state entity that regulates and licenses personnel and operations of the state's gambling industry—principally tribal casinos and cardrooms. In recent years, the Legislature has approved significant expansions of CGCC's staff and budget in order to allow it to regulate the rapidly growing tribal gambling industry. The *2008-09 Governor's Budget* continues this trend, increasing the size of the commission's staff from 70 to 83 positions. Spending for commission operations would grow from $11.2 million in 2007-08 to $13.9 million in 2008-09. Over $10 million of this total is paid from the Indian Gaming Special Distribution Fund (SDF), which was established under the 58 tribal-state gambling compacts that were approved by the Legislature in 1999. While the Governor—not CGCC—is responsible for negotiating compacts with tribes and overall tribal-state relations, the commission has responsibility for administering certain payments and accounts established by the compacts. Accordingly, in this analysis, we discuss several issues relating to these payments and accounts, which go well beyond CGCC's day-to-day operations.

Suspend Use of Tribal Revenues for Transportation Purposes—$101 Million for the General Fund

Current law directs $101 million of annual tribal payments to the state to repay previous loans to the General Fund from the Traffic Congestion Relief Fund. Given the state's budgetary situation, we recommend that the Legislature approve trailer bill language to (1) suspend the use of these payments to repay transportation loans in 2008-09 and (2) direct that the payments be deposited into the General Fund.

Payments Under Tribal-State Gambling Compacts Ratified in 2004. Chapter 91, Statutes of 2004 (AB 687, Núñez), ratified amended gambling compacts between the state and five California Indian tribes:

- Pala Band of Mission Indians (based in San Diego County).
- Pauma Band of Luiseño Mission Indians (San Diego County).
- Rumsey Band of Wintun Indians (Yolo County).
- United Auburn Indian Community (Placer County).
- Viejas Band of Kumeyaay Indians (San Diego County).

The amended compacts provide for the five tribes collectively to pay the state $101 million per year for 18 years. Chapter 91 authorizes the California Infrastructure and Economic Development Bank (I-Bank) to securitize the tribes' payments to the state—meaning that the I-Bank would issue bonds backed solely by these payments—for an up-front payment of up to $1.5 billion. This up-front payment would be used to repay previous loans to the General Fund from the Traffic Congestion Relief Fund (TCRF). By doing so, the Legislature reduced a General Fund obligation to repay the loan. Since 2004, various court challenges have delayed the issuance of the bonds. Previous budgets have dedicated the annual payments to repay a small portion of the TCRF loans each year. These repayments in turn have been used to repay the State Highway Account (SHA) for previous loans made to TCRF. The *2008-09 Governor's Budget* assumes that the bonds are not able to be sold until at least 2009-10 and once again proposes dedicating the $101 million annual payments to repay the TCRF. (Due to the use of several years of the payments to repay TCRF loans and revised estimates, the total amount of the up-front payment that may eventually be generated in a bond sale would be much less than the $1.5 billion authorized by Chapter 91.)

Compacts Give State Discretion for How to Use the Tribal Payments. As required under federal law, the five tribes' amended compacts were approved by the Secretary of the Interior after passage of Chapter 91. Because the securitization of the tribal payments has not yet taken place (after which time the Legislature would have no control over the use of the payments), the state's use of these payments currently is governed by Chapter 91 (which the Legislature can amend) and federal law (which requires the state to comply with the terms of the compact). The compacts with the five tribes include language acknowledging the state's intent to securitize the $101 million through the I-Bank's issuance of bonds, but there is no *requirement* in the compacts that the state use the funds for transportation purposes each year. Accordingly, we conclude that the Legislature, by amending state law, may suspend the use of the tribal payments to repay TCRF loans.

Program Impact. Under current law, the $101 million in tribal payments are to be deposited in SHA to repay previous loans made from that account to the TCRF. The funds would be used to provide cash outlays for capital projects in advance of reimbursements from the federal government. Suspending the tribal payment to the TCRF could delay the funding of highway capital outlay projects by up to that amount.

Recommend Directing $101 Million to the General Fund in 2008-09. Given the state's fiscal condition, we recommend that the Legislature enact trailer bill language to suspend the use of the tribes' payments for repaying TCRF loans for 2008-09 only. This would increase General Fund revenues by $101 million and help close the state's budget shortfall. We do not propose to make the suspension permanent, nor do we propose amending the law authorizing the eventual issuance of bonds by the I-Bank. The recommendation would have no effect on the ability of the five tribes to operate their casino operations or their other payments to the General Fund or the Indian Gaming Revenue Sharing Trust Fund (RSTF), which distributes funds to tribes with no casinos or a small casino (non-compact tribes).

UNDER NEW COMPACTS, SPECIAL DISTRIBUTION FUND SPENDING CAN DIRECTLY AFFECT THE GENERAL FUND

Administration Proposal Unnecessarily Deprives General Fund of $40 Million in Revenue

Annual revenues of the Revenue Sharing Trust Fund (RSTF) have been inadequate to fund the full $1.1 million payment to each of the state's non-compact tribes that is envisioned in the state's gambling compacts. Current law provides that funding the RSTF shortfall is the first priority of Special Distribution Fund (SDF) moneys, but the Governor's budget instead uses General Fund payments from four casino tribes to make up the estimated $40 million RSTF shortfall in 2008-09. We recommend that the Legislature appropriate funds from the SDF to address the RSTF shortfall, per current law. This action would increase General Fund revenues by $40 million. (Add Item 0855-111-0367 to authorize a transfer from the SDF to the RSTF.)

Background. In 1999, the Governor and 58 tribes reached agreements on casino compacts (the 1999 compacts), and the Legislature passed a law approving them. Under the 1999 compacts, tribes acquire and maintain slot machine licenses by paying into the RSTF, an account administered by CGCC that makes payments to non-compact tribes. Under current law, the annual payments to non-compact tribes total $1.1 million for each tribe.

Since its inception, however, the RSTF has lacked sufficient funds to cover the costs of these payments. In prior years, the Legislature has appropriated funds from SDF—another account that receives payments from the 1999 compact tribes—to cure the shortfall. Chapter 858, Statutes of 2003 (SB 621, Battin), specifies that funding the RSTF shortfall is the *first* priority use of SDF funds—followed in descending order by other allowed uses of SDF funds: problem gambling prevention programs, casino regulatory costs of CGCC and the Department of Justice, and grants to local governments affected by tribal casinos.

Recently Approved Compacts Reduce SDF Revenues, But Protect RSTF Payments. In 2007, the Legislature ratified amended compacts with five Southern California tribes. (Four of the compacts were addressed in referenda on the February 2008 ballot, when voters allowed the four compacts to go into effect.) Under the compacts, the tribes will make substantial payments to the General Fund, and their payments to the SDF will end. This will reduce SDF revenues substantially—under the Governor's budget forecast, from $147 million in 2006-07 (before ratification of the amended compacts) to $109 million in 2007-08 and $49 million in 2008-09 (the first full year when the amended compacts are in effect). The five compacts, however, contain provisions to protect payments to non-compact tribes, despite the large drop in SDF revenues. Each of the tribes agreed to make increased payments to the RSTF. In addition, four of the compacts provide that "if it is determined that there is an insufficient amount in the RSTF" to distribute the $1.1 million payments to each non-compact tribe, CGCC must direct a portion of the four tribes' General Fund payments to the RSTF in order to cure the deficiency.

Governor's Budget Directs $40 Million of Tribal General Fund Payments to RSTF. The Governor's budget assumes that this provision of the four tribes' compacts is triggered in 2008-09 and CGCC directs $40 million of tribal payments that otherwise would go to the General Fund to the RSTF.

Governor's Proposal Ignores Current Law, Unnecessarily Reducing General Fund Revenues. We do not agree with the administration's interpretation of the four tribes' compacts and current law. Under current law, the first priority use of SDF funds is curing the RSTF shortfall. The budget forecasts that the SDF will have a $197 million fund balance at the end of 2008-09—equal to about seven years of proposed expenditures from the fund during the budget year. Moreover, under the Governor's budget (which proposes no funding for grants to local governments affected by casinos), the SDF is expected to take in $21 million more in revenues than it spends in 2008-09. The amended compacts raise some issues concerning the future of the SDF, as discussed below. Nevertheless, in this difficult budget year, the administration's plan to use General Fund money to cure

the RSTF shortfall when there is plenty of money available in the SDF makes little sense. If the Legislature were to appropriate funds from the SDF to cure the RSTF shortfall, the provision of the four tribes' compacts requiring a transfer from the General Fund to the RSTF would never be triggered. This would increase General Fund revenues in 2008-09 by $40 million.

Recommend Using SDF—Not the General Fund—to Address the RSTF Shortfall. We recommend that the Legislature add an item to the budget bill authorizing the Director of Finance to order a transfer from the SDF to the RSTF of up to $50 million. (This would provide a cushion if the estimated $40 million RSTF shortfall were to increase.) In conjunction with this action, we recommend the Legislature also adopt provisional language which (1) specifies that any portion of the $50 million not needed to cure the RSTF shortfall remain in the SDF and (2) ensures the General Fund transfer envisioned in the four tribes' compacts will not be triggered.

> 1. The amount of any transfer ordered by the Director of Finance pursuant to this item shall be the minimum amount necessary to allow the Indian Gaming Revenue Sharing Trust Fund to distribute the quarterly payments described in Section 12012.90 of the Government Code and meet its other expenditure requirements. Any remaining portion of the amount authorized to be transferred pursuant to this item shall remain in the Indian Gaming Special Distribution Fund.
>
> 2. The Legislature finds and declares that the amount authorized in this item is expected to be sufficient to allow the Indian Gaming Revenue Sharing Trust Fund to distribute the quarterly payments described in Section 12012.90 of the Government Code during the 2008-09 fiscal year. Accordingly, the California Gambling Control Commission, acting for this purpose as the State Gaming Agency under various tribal-state compacts, shall not direct any funds to the Indian Gaming Revenue Sharing Trust Fund pursuant to Section 4.3.1(l) of the amended tribal-state compacts with the Morongo Band of Mission Indians, the Pechanga Band of Luiseño Indians, the San Manuel Band of Mission Indians, and the Sycuan Band of the Kumeyaay Nation.
>
> 3. The chair of the California Gambling Control Commission shall immediately submit a report to the Director of Finance, the Chair of the Joint Legislative Budget Committee, and the Legislative Analyst if he or she determines that the Indian Gaming Revenue Sharing Trust Fund will not have sufficient funds to distribute the quarterly payments described in Section 12012.90 of the Government Code during the 2008-09 fiscal year after consideration of the funds authorized for transfer by this item. No earlier than 15 days after submission of the abovementioned report, the California Gambling Control Commission may direct funds to the Indian Gaming Revenue Sharing Trust Fund, notwithstanding the requirements of Provision 2.

Lower Appropriations for Local Casino Grants Will Help the General Fund

Citing a critical Bureau of State Audits (BSA) report, the Governor vetoed a $30 million appropriation from the Special Distribution Fund (SDF) for grants to local governments affected by tribal casinos in 2007-08, and his budget for 2008-09 includes no funds for these grants. We recommend that the Legislature—before appropriating any new grant funding—modify existing law to implement BSA's key recommendations. Because grants would no longer be needed for casinos of several tribes with recent compacts, the Legislature should be able to appropriate smaller amounts for the grants in the future. This action will help preserve the solvency of the SDF, thereby reducing fiscal pressures on the General Fund.

Recent BSA Report. The 1999 compacts specify that grants to support local governments affected by tribal casinos are an allowable use of SDF funds. Chapter 858 provides that this is the lowest-priority use of SDF funds—after curing shortfalls in the RSTF, funding problem gambling programs, and covering costs of tribal casino regulatory agencies. Chapter 858 also required the Bureau of State Audits (BSA) to audit the use of SDF moneys. In its July 2007 report, BSA criticized some local government allocations of SDF grant dollars, finding that some funds were given to "projects that have no direct relationship to casinos." In addition, BSA noted that several recent tribal-state compacts, including the five major compacts approved by the Legislature in 2007, require tribes to negotiate directly with counties and cities concerning environmental and public service effects of casino construction and expansion. The BSA report discussed how two counties received $850,000 from SDF in addition to moneys received directly from the tribes. As a result, the report concluded, "that money was unavailable for other local governments that do not negotiate directly with tribes for funds to offset the effects of casinos in their counties." The BSA made several recommendations to the Legislature, including amendments to the law to ensure grants were spent only to "directly mitigate the adverse impacts of casinos" and to revise the grant allocation methodology "so that the allocation to counties is based only on the number of devices operated by tribes that do not negotiate directly with local governments to mitigate casino impacts." We generally concur with BSA's recommendations. Specifically, we recommend that the Legislature take action to implement BSA's key recommendations prior to appropriating any new funding from the SDF for local government grants.

Effects of Recently Approved Compact Amendments. As discussed above, the five recently ratified compacts will reduce SDF revenues substantially. In addition, these compacts—as well as a few others—require tribes to negotiate directly with county and city governments in certain

instances to (1) mitigate the negative environmental effects of casino construction and expansion and (2) provide reasonable compensation to local governments for increased costs of public services resulting from casinos. Because the compacts should increase tribes' direct payments to local governments to address casino impacts, there well be less mitigation to be addressed by SDF grants. As such, the Legislature has an opportunity to reduce the annual amount of SDF grants in the future—from $30 million (the amount vetoed by the Governor in 2007-08) to perhaps somewhere between $10 million and $20 million in future years—reflecting the lower overall need.

Lower Annual Grant Funding Will Help the General Fund Over Time. Earlier, we discussed how the use of SDF funds to cure the annual shortfall in the RSTF can reduce pressure on the General Fund. In the future, as the SDF collects much less money from tribes, the Legislature can take other actions that (1) improve the solvency of the SDF and (2) reduce General Fund spending pressures (particularly from backfilling the RSTF) that would result from any future insolvency of the SDF. Reducing the annual amount of local government grant funding in the future is one such action. By reducing these expenditures, the SDF would have a better chance of maintaining a positive fund balance for a longer period of time, even as it meets its other funding commitments. In the future, if the currently sizable SDF fund balance is depleted, the Legislature will have the following difficult options from which to choose: (1) reducing funding for problem gambling, tribal regulatory, or local government grant costs; (2) using General Fund compact payments—instead of SDF funds—to cure the RSTF shortfall; (3) funding problem gambling, casino regulation, or local government grant costs from the General Fund; or (4) some combination of the above. Accordingly, preserving a positive SDF fund balance for as long as possible helps the condition of the General Fund.

KEY REPORTS FROM COMMISSION TO BE SUBMITTED BY MARCH 1

Withhold Recommendation on All Commission Budget Proposals, Pending Review of the Reports

***The Governor's budget includes several proposals to increase the commission's budget and position authority. We withhold recommendation on all of the proposals pending review of the commission's submissions under the* Supplemental Report of the 2007 Budget Act.**

Withhold Recommendation. The Legislature requested two submissions from CGCC in the 2007-08 supplemental report. Specifically, the re-

ports are to include (1) information on funds generated for the state in the last year by CGCC's audit program and (2) an update on the performance of CGCC's slot machine inspection and testing program. These reports should provide important information to determine if recent increases in staffing have helped the commission increase its effectiveness. This will be an important consideration as the Legislature reviews the Governor's proposals. Accordingly, we withhold recommendation on all of the Governor's budget proposals for CGCC pending review of the supplemental report submissions, which are due on March 1, 2008.

Display of General Fund Tribal Compact Revenues

More Transparency Needed

As a result of tribal-state compacts approved by the Legislature in recent years, a small, but growing, amount of General Fund revenues comes from tribes as a result of their casino operations. The administration's standard budgetary and financial reporting documents do not list tribal revenues with the same degree of prominence as other minor General Fund revenue sources. We recommend that the Legislature direct the administration to display tribal revenues as its own line item in future revenue reports.

Tribal Payments Are a Small, But Growing, Source of General Fund Revenue. Several tribes have agreed to make payments to the state's General Fund in their casino compacts with the state. In 2006-07, tribes' payments to the General Fund totaled $34 million. In 2007, however, the Legislature approved compacts with five Southern California tribes—each with a large casino operation—that will make payments to the General Fund beginning in 2008. While our office and the administration have differed substantially in our respective forecasts of how much money the tribes will pay the state during the next few years, there is little doubt that over the next few years, tribal payments to the General Fund will increase substantially—probably to the hundreds of millions of dollars per year. In addition, as evidenced by the recent debates concerning Propositions 94, 95, 96, and 97, there is significant public interest in knowing how much revenue the tribes are paying the state. However, in the administration's standard budgetary and financial reporting documents (for example, key tables of state revenues submitted with the Governor's budget and monthly bulletins from the Department of Finance), there are no listings of tribal revenues. Instead, the revenues are mixed in with a number of other "miscellaneous" revenues. In contrast, such revenue sources as small as $5,000 in annual revenues (guardianship fees) receive their own line item.

Recommend More Transparency. Transparency is important with any significant new revenue source. First, policy makers need to know how the revenue source is performing in order to craft a balanced budget each year. Second, policy makers and the public need to be able to hold accountable departments—such as CGCC—charged with collecting the payments and ensuring compliance by payers. Using this information, the Legislature would be better equipped to evaluate the revenue provisions of any future proposed tribal-state compacts. For these reasons, we believe that there needs to be more transparency concerning these payments in standard state financial reports. We recommend that the Legislature direct the administration to display tribal revenues as its own line item in future revenue reports.

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 (SUTs) 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 geographic district and the State Controller.

The Governor's budget proposes $430 million in support of BOE operations, with $242 million from the General Fund and most of the remainder from local government reimbursements. The proposed level of support represents an overall increase in funding of $33 million ($20 million General Fund) from the 2007-08 level. The number of personnel-years (PYs) for BOE is budgeted to increase from 3,800 to 4,035, with the growth concentrated in SUT activities.

E-Services Deliver a Return on Investment

We recommend that the Board of Equalization's budget be reduced to account for savings associated with increased use of electronic filing of sales and use tax returns and the associated reductions in paper processing. We also recommend mandatory electronic filing for larger taxpayers to further increase efficiencies. (Reduce Item 0860-001-0001 by $1.4 million.)

Background. The BOE has been converting to electronic technologies in the filing of tax returns and remittances, as well as the processing of these returns. The advantages of shifting to electronic remittances and

returns are significant. From the taxpayers' perspective, using electronic filing can minimize record keeping requirements, increase filing accuracy, and reduce costs. From a tax agency perspective, electronic technologies decrease processing time, reduce storage costs, minimize personnel requirements, improve data accuracy, and facilitate sharing of information among the different agencies for enforcement and compliance purposes.

Electronic Processing Results in Savings. From a budgetary perspective, 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 staff hour. By comparison, only 62 paper remittances are processed per staff hour. This cost differential can translate directly into budget savings. In addition to processing savings, additional savings typically occur because the electronic submissions of remittances and returns are more accurate than their paper counterparts, thus requiring less follow-up contact with the taxpayer to correct inaccuracies.

BOE's Efforts. Since 2005-06, BOE has undertaken several initiatives and pilot programs to increase electronic filings. To date, BOE has instituted these programs on a voluntary basis without mandating that any taxpayer file electronically. As part of the 2007-08 budget process, the department committed to the Legislature that it could achieve $930,000 in General Fund savings in 2008-09, based upon the department's projected 7.5 percent growth in electronic filing of returns (from 2.5 percent of all filings to 10 percent of all filings). Information provided by BOE indicates some growth in electronic filing of returns in the current year. The department expects additional growth to continue in the budget year in order to meet the original target of 10 percent. Yet, the Governor's budget does not reflect any administrative savings from this trend.

Recommend Accounting for Savings. Based on current estimates, we recommend that the Legislature reduce BOE's budget by $930,000 for 2008-09 to account for savings associated with increased use of electronic return processing and associated reductions in the amount of paper printing and mailings.

Recommend a Plan for Increased Electronic Filing. In addition, in order to increase electronic filing participation, we recommend that the department mandate electronic filing for larger taxpayers. The FTB already has such requirements. The BOE currently mandates electronic *payment* for all SUT accounts that average over $10,000 or more in tax due per month. We recommend that these same thresholds be used as a starting point to mandate electronic filing. This would result in approximately a 4.5 percent increase in electronic filing and additional General Fund savings of about $500,000 in the budget year.

Some Tax Gap Auditors Would Provide Minimal Benefit

We recommend that the Legislature delete $9.4 million ($5.9 million General Fund) of proposed spending on sales and use tax gap enforcement activities. Many of the proposed activities would provide minimal revenue benefit. The corresponding net reduction in budget-year revenues would be about $15 million ($10 million General Fund). Our recommendations for the Franchise Tax Board would more than make up for this revenue loss. (Reduce Item 0860-001-0001 by $5.9 million.)

Background. There is a significant 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 voluntarily remitted taxes is known as the "tax gap." Using federal estimates and state sources of information, BOE has pegged California's tax gap associated with the SUT at $2 billion annually. The BOE and federal officials indicate that the SUT tax gap is most associated with noncompliance in remitting the use tax. (The use tax is the tax paid on items purchased out of state—for example, by telephone, over the Internet, by mail, or in person—for use in California when the seller does not collect the SUT.) Approximately 60 percent of the SUT gap is related to the use tax, while the remainder of the SUT gap is related to nonfiling by those with a sales tax liability and underreporting of SUT liabilities by registered taxpayers. As in the case of all SUT administrative costs, a portion of the costs to close the tax gap are paid by local governments. Any increased SUT revenues are also shared between the state and local governments.

Administration's Proposal. The administration proposes five major SUT gap initiatives for the budget year. These proposals would add 137 PYs in 2008-09, at a cost of $14 million ($9 million General Fund), increasing to 254 PYs in 2009-10, at a cost of $23 million ($15 million General Fund). As Figure 1 (see next page) shows, the initiatives are projected to generate $32 million ($20 million General Fund) in additional revenue in 2008-09, almost doubling to $61 million ($38 million General Fund) in 2009-10. The initiatives are:

- ***Expanded Bankruptcy and Out-of-State Collections.*** This proposal provides resources for BOE to contract with FTB for increased information sharing. The BOE would use FTB's bankruptcy court records to match noncompliant taxpayers that have bankruptcy plans under court review. The BOE would then obtain a lien priority in those plans, in order to recoup unpaid SUT. The proposal also allocates additional resources for out-of-state collectors to collect SUT debts from these bankrupt out-of-state businesses. The proposal would fund five new PYs, at a cost of $545,000 ($354,000 General Fund) in 2008-09, increasing to nine

PYs and $735,000 ($478,000 General Fund) in 2009-10. The BOE estimates it would raise $4.2 million ($2.6 million General Fund) annually, beginning in 2008-09.

Figure 1

SUT Gap Initiatives

(All Funds, Dollars in Thousands)

	Costs		Revenues		Average Benefit/ Cost Ratio
Initiative	**2008-09**	**2009-10**	**2008-09**	**2009-10**	**2009-10**
Expanded Bankruptcy/ Out-of-State Collection	$545	$735	$4,201	$4,201	5.7
In-State Service Businesses	4,693	8,411	13,609	26,358	3.1
Collection Improvements	1,325	2,126	2,932	5,772	2.7
Audit Improvements	7,002	11,330	11,578	24,570	2.2
Non-Filers and Tax Evaders	351	318	—	—	—
Totals	**$13,916**	**$22,920**	**$32,320**	**$60,901**	**2.7**

- ***In-State Service Businesses.*** This proposal targets service industry businesses that are likely to have failed to remit use taxes owed. The proposal would fund 52 PYs in 2008-09 at a cost of $4.7 million ($3.1 million General Fund), increasing to 109 PYs and $8.4 million ($5.5 million General Fund) in 2009-10. The funds would be used for audits, education, outreach, and collection activities associated with noncompliant taxpayers within the state. Of the total, about $884,000 is for field audit and collection activities, with the remainder for headquarters activities. The BOE estimates the program would raise $14 million ($8.8 million General Fund) in 2008-09, increasing to $26 million ($16 million General Fund) in 2009-10.
- ***Collection Program Improvements.*** This initiative allocates additional resources for collectors in BOE's field offices. The new positions would focus on existing collection workloads that are currently not being addressed. The proposal would fund 14 new PYs, at a cost of $1.3 million ($861,000 General Fund) in 2008-09,

increasing to 24 PYs and $2.1 million ($1.4 million General Fund) in 2009-10. The BOE estimates it would raise $2.9 million ($1.8 million General Fund) in 2008-09, increasing to $5.8 million ($3.7 million General Fund) in 2009-10.

- ***Audit Program Improvements.*** This proposal allocates additional resources for audits and collection activities associated with both in-state and out-of-state noncompliant taxpayers. The proposal would fund 63 new PYs, at a cost of $7 million ($4.6 million General Fund) in 2008-09, increasing to 110 PYs and $11 million ($7.4 million General Fund) in 2009-10. The BOE estimates it would raise $12 million ($7.6 million General Fund) in 2008-09, increasing to $25 million ($16 million General Fund) in 2009-10.
- ***Non-Filers and Tax Evaders.*** This proposal focuses on SUT noncompliance of nonstationary vendors, cash-based businesses, and Internet sellers and purchasers. The funds would allow BOE to create three, three-year pilot programs that would identify and issue permits to each of these three groups of noncompliant taxpayers. The proposal would fund three PYs at a cost of $351,000 ($227,000 General Fund). There are no revenues associated with this proposal. Rather, BOE would use the results of these pilots to better inform its procedures and general approach to these segments of the tax gap in the future.

Some Revenues Are Understated. Our analysis indicates that the administration's proposals for expanded bankruptcy and out-of-state collections would generate more revenue than indicated. Due to inconsistent assumptions about the amount of revenue generated by new collectors, the administration's revenue estimates for this initiative are understated. Based on our review, we recommend the Legislature score an additional $84,000 in revenue in 2008-09 ($53,000 General Fund) and an additional $1.3 million in revenue in 2009-10 ($0.8 million General Fund) and annually thereafter.

Some Initiatives Have Little Benefit. As shown in Figure 1, most of the administration's initiatives have low benefit-cost ratios. For instance, BOE's proposed audit improvement and collection improvement initiatives would bring in less than $3 for each $1 spent by 2009-10. In contrast, FTB's tax gap proposals would bring in an average of $10 for each $1 spent. We therefore recommend rejecting the audit improvement and collection improvement initiatives. The field audit and collection piece of the in-state service businesses proposal faces similar shortcomings. The 9.5 PYs associated with these activities would cost about $884,000 in 2008-09 and produce $1 million in revenue. A year later, the new staff would grow to 37 PYs and cost about $3.4 million in return for less than twice that amount in revenue. The BOE's revenue estimates are subject to some uncertainty,

particularly for new tax gap activities. In order to ensure that the new activities are a good return of taxpayer funding, therefore, we recommend the Legislature delete these audit and collection activities. After adjusting for the field component, we recommend approval of $3.8 million of the in-state service businesses initiative at headquarters due to a higher benefit-cost ratio.

Focus Pilot Programs. As described above, BOE proposes to conduct three pilot programs which are not expected to generate near-term revenues. Given the state's limited resources, we recommend limiting the pilot programs to those areas which offer the greatest potential for a substantial revenue return in the future. In our view, the Internet sellers activities pilot program meets this criterion.

Summary of Recommendations. Due to the poor expected revenue benefit associated with audit, collection, and pilot program activities, we recommend that the Legislature delete $9.4 million from BOE's request. Specifically, we recommend deleting $7 million from audit improvements, $1.3 million from collection improvements, $884,000 from in-state service business activities, and $232,000 from nonfiler and tax evader pilot programs. Figure 2 summarizes our recommended approach, which also adjusts for the understated revenue returns described above. As we

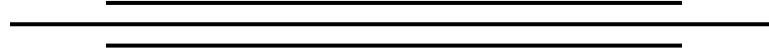
Figure 2

SUT Gap Initiatives: LAO Recommendation

(All Funds, Dollars in Thousands)

Initiative	Costs		Revenues		Average Benefit/ Cost Ratio
	2008-09	2009-10	2008-09	2009-10	2009-10
Expanded Bankruptcy/ Out-of-State Collection	$545	$735	$4,285	$5,513	7.5
In-State Service Businesses	3,809	5,011	12,609	20,658	4.1
Collection Improvements	—	—	—	—	—
Audit Improvements	—	—	—	—	—
Non-Filers and Tax Evaders (Internet sellers)	119	106	—	—	—
Totals	**$4,473**	**$5,852**	**$16,894**	**$26,171**	**4.5**
Difference From Administration	**-$9,443**	**-$17,068**	**-$15,426**	**-$34,730**	**1.8**

discuss in the "Franchise Tax Board" write-up (Item 1730), some of the reduced resources can be better used for tax gap activities at FTB, resulting in a net increase in General Fund revenues at a lower cost compared to the Governor's budget.



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 corporation tax (CT) programs and—with the assistance of the Employment Development Department—California's personal income tax (PIT). The FTB also administers the Homeowners' and Renters' Assistance Programs. In addition, 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 FTB.

The Governor's budget proposes $650 million ($554 million General Fund) and 5,348 personnel-years (PYs) in support of FTB's operations. Compared to the current-year budget, this represents a decrease of $45 million (6.5 percent) in total funding, but a General Fund increase of $19 million. The budget proposes increases for several measures to close the state's tax gap ($16 million General Fund), continued implementation of the Child Support Automation System project ($7.9 million General Fund), ongoing activities associated with expansion of the court-ordered debt collection programs ($3.9 million in special funds), and various information technology improvements ($1.6 million General Fund). These increases are partially offset by decreases due to one-time cost reductions, expiring programs, and lease-revenue bond debt-service adjustments.

ADDITIONAL REVENUES FROM CLOSING THE TAX GAP

Administration's Revenues Scored Too Low

We recommend the Legislature score additional General Fund revenues of $100,000 in 2008-09 and $2.1 million in 2009-10 due to technical miscalculations in the administration's tax gap budget proposal.

Background. There is a significant 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 voluntarily 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 the PIT and CT at $6.5 billion annually. The FTB and federal officials indicate that the tax gap is most associated with certain types of activities, taxpayers, and occupations—suggesting that particular targeted efforts should be made to best address the gap and limit the associated revenue losses. More than two-thirds of the gap results from underreporting of income (such as failure to report "off-the-books" income), while the remainder of the gap can be attributed to 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 certain other income) and the absence of third-party reporting (two major categories of such reporting include interest and dividends paid by financial organizations).

Governor's Proposals. The administration requests funding of $16 million from the General Fund and 197 positions for 2008-09 to develop additional tax gap initiatives. Specifically the proposals would:

- Fund a variety of efforts to increase tax compliance ($9.9 million and 132 PYs).
- Provide additional audit resources ($4 million and 35 PYs).
- Increase fraud prevention efforts in the areas of claims for the child dependent care credit and W-2 fraud ($2.4 million and 30 PYs).
- Fund a compliance behavior study on the effect of FTB's various compliance activities on taxpayer behavior ($100,000).

The administration estimates that the proposal would generate General Fund revenues of $93 million in 2008-09 and $164 million in 2009-10.

Revenue Estimate Is Understated. Due to technical miscalculations, the administration's revenue estimate does not account for all revenues generated by the proposed fraud prevention efforts. Based on our review, we recommend the Legislature score an additional $100,000 in General Fund revenues in 2008-09 and an additional $2.1 million in General Fund revenues in 2009-10, and annually thereafter.

Recommend Additional Efforts

We recommend that the Legislature appropriate an additional $3.9 million to the Franchise Tax Board to fund four additional tax gap enforcement efforts. These efforts would generate an additional $58 million in 2008-09 General Fund revenues. (Augment Item 1730-001-0001 by $3.9 million.)

Recommend Additional Tax Gap Efforts. In addition to the PIT gap initiatives identified by the administration, we recommend the Legislature provide an additional $3.9 million of General Fund support for four additional PIT gap initiatives. We describe each of these proposals below. In total, we estimate that these proposals would provide more than $50 million in additional General Fund revenues annually, as summarized in Figure 1. In the BOE write up in this chapter (Item 0860), we recommend a $5 million General Fund reduction to the administration's tax gap proposal. Combined between the two tax agencies, therefore, we recommend spending slightly less than the administration—yet with the benefit of tens of millions of additional dollars in revenues.

Figure 1

LAO Recommended Franchise Tax Board Tax Gap Funding

(General Fund, Dollars in Millions)

	Costs		Revenues		Average Benefit/Cost Ratio
	2008-09	2009-10	2008-09	2009-10	2009-10
Administration's Proposals	**$16.4**	**$16.4**	**$93**	**$166**	**10.1**
Compliance enhancement	9.9	9.9	71	125	12.7
Audit resources	4.0	4.0	10	20	5.0
Fraud prevention[a]	2.4	2.4	12	21	8.6
Compliance behavior study	0.1	0.1	—	—	—
Additional LAO Proposals	**$3.9**	**$3.6**	**$58**	**$56**	**15.6**
Increased Revenue Agent's Reports	2.5	2.5	40	40	16.0
Revenue Agent's Reports backlog	0.2	—	6	—	—
Out-of-state audit workload	1.1	1.1	10	10	9.1
Modify group income tax return provisions	0.1	—	2	6	—
Totals	**$20.3**	**$20.0**	**$151**	**$222**	**11.1**

[a] Revenues reflect LAO recommended scoring.

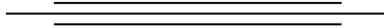
Increased Number of Revenue Agent's Reports. The Internal Revenue Service (IRS) has recently dedicated additional resources targeted toward high-income taxpayers, particularly those that work for themselves and do not have an employer that withholds income taxes. Compared to 2006, the IRS in 2007 audited 14 percent more taxpayers with incomes of $100,000 or more, 29 percent more taxpayers with incomes of $200,000 or more, and 84 percent more taxpayers with incomes of $1 million or more. The IRS plans to further increase the number of these audits in 2008. The computation of a taxpayer's state PIT liability generally begins with federal taxable income (subject to state-specific adjustments). The adjustments to federal taxable income that result from the increased federal audits, therefore, will almost always result in additional state PIT liability. When an adjustment to a filed federal income tax return is proposed as a result of an IRS examination and audit, the notice of the proposed adjustment is called a Revenue Agent's Report (RAR). All RARs are automatically shared with FTB. We recommend that the Legislature provide additional resources to FTB in order to focus on the additional RARs generated by the federal audits. An investment of $2.5 million would generate an additional $40 million in General Fund revenues in 2008-09, and annually thereafter.

RAR Backlog. The FTB also has a backlog of previously issued RARs. By providing additional resources for overtime pay, approximately $6 million in General Fund audit revenues could be accelerated to the budget year on a one-time basis. The proposal would have a General Fund cost of approximately $200,000 in 2008-09.

Additional Out-of-State Audit Workload. The FTB's out-of-state offices currently have audit workloads that are not being addressed. By allocating additional resources for auditors in FTB's field offices, these audits could be completed. The proposal would have a cost of approximately $1.1 million in 2008-09, and would raise an additional $10 million in General Fund revenues in 2008-09, and annually thereafter.

Modify Group Income Tax Return Provisions. Currently, California allows certain nonresidents who receive income from a pass-through entity (partnerships or S corporations) that derives income from California sources or is doing business in California to elect to have the pass-through entity file a group nonresident return on their behalf. The rationale for this practice is to make filing state returns more convenient. To take advantage of this filing procedure under current law, individuals must (1) be full-year nonresidents of California and (2) not have California taxable income in excess of $1 million. We recommend that the Legislature amend current law to expand who can file a group nonresident return. Primarily, this would involve authorizing individuals with more than $1 million in California taxable income to file a group return. By authorizing a pass-though entity to submit a return, more nonresidents who are not currently filing returns

should begin to file via a group return. In addition to increasing General Fund revenues, this proposal would increase revenues to the Mental Health Fund (Proposition 63) from those individuals with more than $1 million in taxable income. The proposal would have a one-time General Fund cost of $101,000 in 2008-09 and would provide additional revenues of $6 million ($2 million General Fund) in 2008-09, increasing to $13 million ($6 million General Fund) in 2009-10, and annually thereafter.



CALPERS—PENSION CONTRIBUTIONS
(1900/CONTROL SECTION 3.60)

Retirement system boards, such as the California Public Employees' Retirement System (CalPERS) Board of Administration, have the authority to undertake actuarial reviews of their pension systems and to administer funds for the benefit of system members. Employees and retirees of the state and many local governments are members of CalPERS. Assets and liabilities related to each public employer are accounted for separately. Control Section 3.60 specifies the state's contribution rates for state employees in CalPERS.

In order to fund defined monthly benefits for retired public employees, CalPERS uses (1) returns generated from its investment portfolio—which was valued at $246 billion as of January 10, 2008—and (2) contributions made by public employees and employers. The system reported that actuarial accrued liabilities of its Public Employees' Retirement Fund (PERF) were 87 percent funded as of June 30, 2006. This means the PERF had a $29.1 billion unfunded actuarial accrued liability (UAAL) at that time. Of this amount, $15.4 billion represents the portion of the UAAL attributable to the state. Local governments and school districts are responsible for the other liabilities.

State law and labor agreements define retirement benefits that state employees earn as part of their compensation, as well as employees' contributions to cover part of the costs of those benefits. The state also makes employer contributions to CalPERS. These contributions cover the estimated cost of pension benefits earned by employees in each pay period (normal cost), as well as costs to eliminate (over time) any unfunded liabilities for employees' and retirees' prior service. In defined benefit programs, such as those of CalPERS, unfunded liabilities emerge when actuarial assumptions related to annual investment returns, employee pay levels, and demographic factors are not met. Since these trends cannot be predicted with precision, CalPERS' contribution rates change from year to year—sometimes increasing and sometimes decreasing.

Other items in the budget outside of the control section also relate to CalPERS, including Item 1900 (which budgets certain CalPERS operational funds) and Item 9650 (which appropriates the majority of funds required to meet health and dental benefit obligations to state government and California State University retirees).

Budget Assumes Stable Pension Contribution Rates

The Governor's budget assumes that 2008-09 pension contribution rates remain the same as in 2007-08. The 2008-09 contribution rates will be based on investment returns and demographic trends in the California Public Employees' Retirement System (CalPERS) through June 30, 2007. These trends currently are under review by CalPERS actuaries as part of the annual actuarial report process, which typically concludes in May. We withhold recommendation on the 2008-09 CalPERS' contribution rates pending their final determination through this process.

Healthy Investment Returns Have Helped Reduce Pension Rates Recently. In 2005-06, the investment return of CalPERS' assets totaled about 12 percent, compared to the system's normal projected investment return of under 8 percent annually. This favorable investment return contributed to the slight declines in the state's contribution rates for most pension classes during 2007-08, as shown in Figure 1. The state's 2008-09 pension contribution rates will be based in part on CalPERS' investment performance during 2006-07, when its assets earned a return of over 19 percent. This outstanding performance was led by a (1) 30 percent return on international stocks, (2) 23 percent return on alternative investments such as private equity and venture capital, (3) 21 percent return on U.S. stocks, and (4) 20 percent return on real estate holdings.

Other Demographic Factors May Affect Contribution Rates. The CalPERS' actuaries report that after many public employees' pension benefits were enhanced in 2000, assumptions about the numbers of retirements over the next few years were decreased after an initially anticipated rise in retirement activity failed to materialize. Recently, however, CalPERS' actuaries have noted increases in state employee retirements not assumed in the system's current actuarial models. In 2004-05, for example, retirements were 50 percent higher than anticipated by these models, and in 2005-06, while retirements declined, they were still 26 percent greater than actuarial assumptions. One possible cause of the changes is the enactment of laws allowing CalPERS members to purchase up to five years of additional retirement service credit (commonly known as "airtime"). The system has reported that it is conducting an "experience study" to examine these and other demographic changes in more detail. Based on the study, the system may modify its actuarial assumptions about future retirement

activity or increase the purchase costs of airtime. These pension system demographic issues temper what would otherwise be our expectation of declines in the state's pension contribution rates.

Figure 1

State Retirement Contribution Rates

1995-96 Through 2008-09 (As Percent of Payroll)

Fiscal Year	Misc. Tier 1	Misc. Tier 2	Industrial	Safety	Peace Officer/ Firefighter	Highway Patrol
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	17.0	16.8	17.9	19.3	24.5	31.5
2007-08	16.6	16.6	17.3	18.8	25.6	32.2
2008-09[a]	16.6	16.6	17.3	18.8	25.6	32.2

[a] Budgeted.

Total Contributions Should Rise, Due to Larger Payroll. While the Governor's budget assumes that required state contribution rates to CalPERS remain steady, it also assumes that the state's total contributions increase due to payroll growth. Figure 2 (see next page) shows recent trends in the state's total contributions from the General Fund and special funds, including the amount assumed in the Governor's budget. This budget assumes that state contributions grow from $2.7 billion in 2007-08 to $2.8 billion in 2008-09, up 3 percent. Over one-half of this amount (an estimated $1.6 billion) would be paid from the General Fund.

Withhold Recommendation. We withhold recommendation on the control section pending CalPERS' final determination of required 2008-09 contribution rates, which typically occurs in May. The administration should be able to submit any necessary revisions to the control section and in budgeted pension contribution funds with the May Revision or soon thereafter.

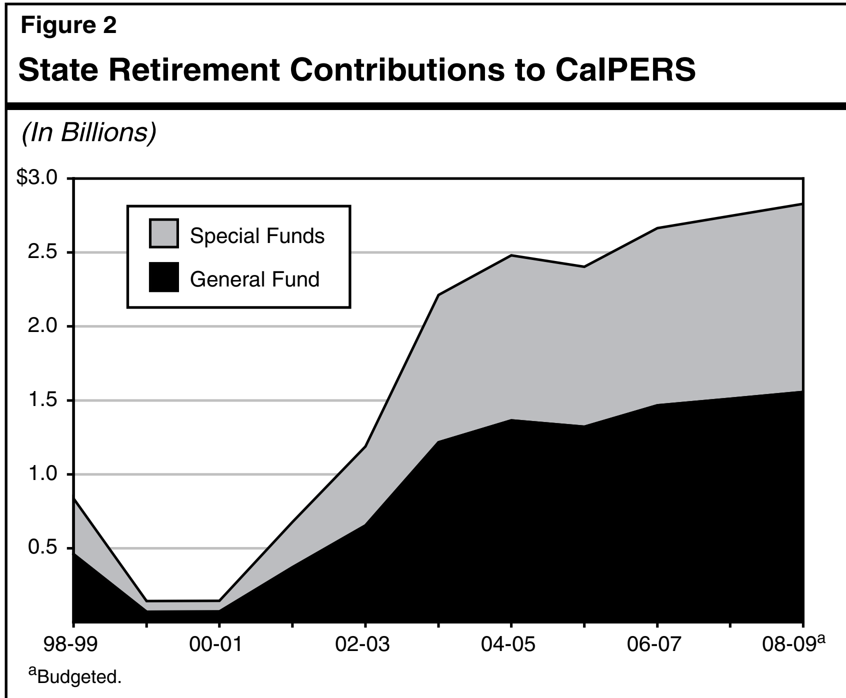


Figure 2

State Retirement Contributions to CalPERS

CalPERS' Inconsistency in Discussing Its Funded Condition May Confuse Policy Makers and Public

In 2007, the California Public Employees' Retirement System (CalPERS) changed its method for communicating the funding status of its pension funds to policy makers and the public. The new method suggests that CalPERS' major pension funds have eliminated nearly all of their unfunded liabilities, despite the fact that CalPERS' own method for setting employer pension contribution rates continues to identify large unfunded liabilities. We believe that this inconsistency may confuse policy makers and the public concerning the financial condition of CalPERS' pension funds.

CalPERS' Policies for Setting Employer Pension Contribution Rates. Almost all public pension systems disclose their unfunded liabilities using a smoothed, actuarially determined value of assets. These figures, in turn, are used to determine employer contribution rates. In 2005, the CalPERS Board of Administration adopted a policy to smooth its pension funds' asset gains and losses over 15 years when setting employer contribution rates—a change from the prior policy (still used by many other pension funds) to smooth changes of asset values over three years. This policy was

implemented to prevent the volatility in employers' annual contribution rates that occurred in the late 1990s and early 2000s due largely to swings in the stock market.

CalPERS Has Started Using the Market Value of Assets in Discussing Unfunded Liabilities. The CalPERS' large unfunded pension liabilities—recently exceeding $20 billion for the PERF—have been a major issue for the public and policy makers in recent years. In 2007, CalPERS changed how its officials and key public documents disclosed its unfunded pension liabilities. Instead of describing its liabilities based on the smoothed value of assets used to set employer rates, CalPERS began publicly disclosing this financial indicator based on a calculation that uses the *market value* of its assets. (In technical documents CalPERS also discloses unfunded liabilities based on the earlier method of calculation.) Due to CalPERS' strong investment gains in recent years, this change allowed the system suddenly to start discussing how its major pension funds were fully funded or approaching "full funding" during 2007.

Under the Method Used to Set Employer Rates, CalPERS Still Has Significant Unfunded Liabilities. The CalPERS' new method of discussing its unfunded liabilities is inconsistent with its method for setting employer rates. We believe this may lead to confusion among policy makers and the public about the financial condition of CalPERS' pension funds. With the smoothed value of assets used by the system to set employer rates, PERF had a $29 billion unfunded liability as of June 30, 2006 (meaning its liabilities were 87 percent funded). With the market value of assets now used by the system in discussing its unfunded liabilities, PERF had a $17 billion unfunded liability on the same date (suggesting its liabilities were 93 percent funded). This is because the market value of PERF assets was $12 billion greater on that date than its smoothed value of assets. Given the system's strong investment performance in 2006-07 and the resulting growth in the market value of its assets, the disparity between these two measures probably expanded in subsequent months through the end of 2007. Accordingly, CalPERS has claimed its system is now approaching full funding.

CalPERS Should Be Consistent in Discussing Unfunded Liabilities. In our *Analysis of the 2006-07 Budget Bill* (see page F-121), we discussed the merits of CalPERS' policy to reduce volatility in public employers' contribution rates. The system's new method for discussing unfunded liabilities means that this key pension system indicator now will be subject to the same type of volatility CalPERS sought to avoid in contribution rates. In the short term, the new method may allow CalPERS to report the elimination or near-elimination of its unfunded liabilities. This is a concern because it may lead some policy makers and employee groups to conclude incorrectly that the state could lower pension contribution rates or increase pension

benefits. We believe that the system should disclose its unfunded liabilities in a manner consistent with its contribution rate methodology—using the smoothed value of assets. This would be consistent with the accepted method of reporting liabilities in public financial statements. It would also make CalPERS' disclosures more consistent with those used by nearly all other public pension systems.

Recommend Applying Commission's Independent Performance Audit Recommendation to CalPERS

The Public Employee Post-Employment Benefits Commission recommends that all public pension plans have periodic performance audits performed by independent auditors. Current law requires the California Public Employees' Retirement System (CalPERS) to have an independent audit annually, but restricts the ability of the Bureau of State Audits or Department of Finance to review CalPERS' books and operations. This restriction lacks clarity and could be construed to limit the Legislature's authority to request performance audits of certain CalPERS programs. Accordingly, we recommend that the Legislature enact a law that repeals or clarifies this restriction.

PEBC Report Contains 34 Recommendations for the State and Local Governments. The Public Employee Post-Employment Benefit Commission's (PEBC's) over-300-page report lists 34 recommendations for California state and local policy makers—grouped into eight general categories. The report also includes results from new surveys of the financial condition of the state's public retirement systems, as summarized in the nearby text box. The report contains several recommendations to promote independent analyses of pension system operations and transparency for policy makers, system members, and the general public.

Commission Recommends More Independent Audits of Pension Systems. The PEBC recommends that "all public pension plans should have periodic performance audits performed by an independent auditor." Pension systems, including CalPERS, already are required to hire an outside, independent accounting firm each year to audit their financial records to ensure compliance with generally accepted accounting rules. However, current law, the commissioners conclude, "does not provide for regular performance audits of public retirement systems," which "could look at any aspect of the workings of a retirement system (administrative, investment, or benefit delivery), compare policies to practice, and provide valuable insight into how operations might be improved." We concur with this recommendation.

Current Law Restricts Ability of Legislature to Request Such Audits. Section 20228 of the Government Code requires CalPERS to have its

financial records audited annually by an independent accountant. The law, however, states that "the audits shall not be duplicated by the Department of Finance (DOF) or the State Auditor." In state government, DOF and the Bureau of State Audits (BSA) are the principal entities that the Legislature may direct to conduct performance audits of government programs. This code section is unclear if these restrictions also apply to DOF and BSA concerning performance audits.

Recommend Repealing or Clarifying Restriction. Accordingly, we recommend repealing or clarifying the law so that DOF and BSA may conduct performance audits on the programs of CalPERS. This would allow the Legislature, including the Joint Legislative Audit Committee, to request performance audits of CalPERS without any restrictions, similar to the way that lawmakers may request audits of other state programs.

$64 Billion of Unfunded Pension Liabilites Among State and Local Pension Systems

Commission Was Directed to Identify State and Local Liabilities. The Public Employee Post-Employment Benefits Commission (PEBC) was asked to estimate the total amount of unfunded pension liabilities for the state and local governments and make recommendations for how policy makers should address these liabilities. The PEBC found that the total amount of unfunded public pension liabilities in California was $63.5 billion. With unfunded actuarial accrued liabilities of nearly $50 billion between them, the two largest public pension funds—the California Public Employees' Retirement System and the California State Teachers' Retirement System—account for the majority of the liabilities, which are attributable to the state, California State University, and local government employers enrolled in the two systems. The PEBC report stated that the aggregate funded ratio for all public pension systems in the state was 89 percent. The commission relied on conventional pension statistics in compiling this data.

In General, Sound Recommendations for Policy Makers. We are still reviewing the commission's thorough report. In general, we concur with the spirit of its recommendations—to enhance the financial status, transparency, and governance of the state's public retirement systems. We believe that adoption of some of the commission's key suggestions by state and local leaders will help policy makers in the difficult task of considering what retirement benefits are best suited for each public entity's workforce.

California State Teachers' Retirement System (1920)

The California State Teachers' Retirement System (CalSTRS) administers pension and other benefits for about 800,000 current and former educators of school and community college districts. In order to fund defined monthly benefits to eligible retired teachers, CalSTRS uses (1) returns generated from its $174 billion investment portfolio and (2) contributions made pursuant to state law by teachers, districts, and the state.

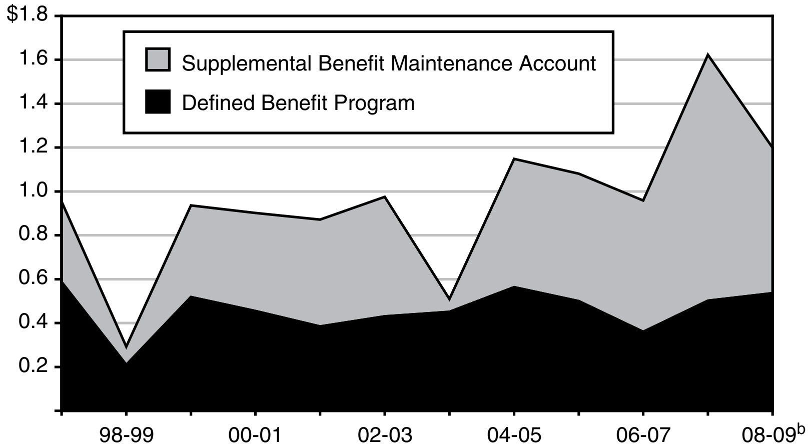
Under current law, the state must make two separate annual payments to CalSTRS from the General Fund:

- A payment of about 2 percent of prior-year teacher payroll for CalSTRS' Defined Benefit (DB) Program, which funds the basic pension benefits of retired teachers.
- A payment of 2.5 percent of prior-year payroll for the Supplemental Benefit Maintenance Account (SBMA), which is also known as the "purchasing power account." The SBMA funds prevent erosion of the purchasing power of retirees' benefits by the effects of inflation.

Figure 1 shows that the state's contributions to CalSTRS in recent years have been volatile due to several prior legislative actions that have produced one-time budget savings. The *2008-09 Governor's Budget* proposes $1.1 billion to cover the two regular annual payments to the DB Program and SBMA, about the same amount as those two regular payments during 2007-08. In addition, the budget reflects increased expenditures in 2007-08 and 2008-09 due to a court order described below which reverses legislative action in 2003-04. In total, the administration estimates that state contributions to CalSTRS will total $1.6 billion in 2007-08 and proposes $1.2 billion in contributions in 2008-09.

Figure 1

State Contributions to CalSTRS[a]



[a] State contributions declined in 1998-99, 2003-04, and 2006-07 due to statutory actions that generated one-time budget savings. Contribution rates for the Defined Benefit Program were adjusted pursuant to statutes in 1998 and 2000.
[b] Proposed.

System's Funded Status Improved in Most Recent Valuation

The most recent California State Teachers' Retirement System actuarial valuation reported that the system's unfunded liability declined for a second consecutive year to $19.6 billion in 2006. Measured as a percentage of the system's total liabilities, this unfunded liability is about average among comparable pension systems.

System Is 87 Percent Funded, With $19.6 Billion Unfunded Liability. The system's actuaries reported that, as of June 30, 2006, CalSTRS' unfunded actuarial obligation for its DB Program was $19.6 billion, and the actuarially determined value of DB Program assets on hand was $150 billion (the bulk of the system's assets). This means that the program is 87 percent funded. According to a recent report by the Pew Center for the States, the average state pension system in the U.S. is 85 percent funded.

Proposal to Address Liabilities Would Require Legislative Approval. In 2006, the Teachers' Retirement Board (TRB), the governing body of CalSTRS, formulated a general proposal to address the unfunded liability but has yet to formally submit it to the Legislature. Among other provisions, the proposal would give TRB the authority to increase required

contributions by teachers, districts, and the state. The Legislature must approve any such change in TRB's authority.

Proposal to Delay Court-Ordered Interest Payment Is Risky

The administration complied with part of a recent court order and paid in 2007-08 $500 million withheld from the California State Teachers' Retirement System (CalSTRS) purchasing power account in 2003-04. To comply with another part of the order—to pay over $200 million in interest—the administration proposes to pay the costs over a three-year period beginning in 2008-09. Unless CalSTRS and other parties in the case agree to this payment plan, we recommend that the Legislature reject it because it probably would be legally unworkable. If CalSTRS and the other parties do not agree to the plan, we recommend that the Legislature comply with the court order and appropriate funds to pay the entire interest obligation, as well as other court-ordered costs, in the* 2008-09 Budget Act *or earlier.

Administration Lost Its Appeals on CalSTRS SBMA Lawsuit. In our *Analysis of the 2007-08 Budget Bill* (see page F-67), we described the lawsuit related to the state's withholding $500 million from CalSTRS' purchasing power account on a one-time basis in 2003-04. In 2007, an appellate court ruled against the administration, and the California Supreme Court declined to hear further appeals. To comply with the court order, the state made a $500 million principal payment to CalSTRS in September 2007. In addition to the principal payment, the courts have ordered the state to pay (1) interest in specified amounts "until the date that the $500 million is deposited into the SBMA" and (2) costs of the other parties in the case. The administration estimates that the interest costs total about $210 million. The other parties' legal costs may total around $11,000.

Budget Proposal Would Pay Interest Costs Over Three-Year Period. The $500 million principal payment was paid to CalSTRS under the terms of the continuous appropriation for the SBMA. In contrast, the payment of interest requires an appropriation by the Legislature. The administration proposes that the Legislature approve a plan to pay the court-ordered interest over three years beginning with a payment of $80 million in 2008-09. Specifically, the administration proposes that the payments for interest and court costs be appropriated in the annual claims bill.

Ability to Delay Interest Payments Is Uncertain. The court order does not mention the possibility of paying interest over a multiyear period. In addition, we are not aware of precedent in similar cases to pay interest costs over a multiyear period without agreement from the other litigating parties. (In this case, the other parties are CalSTRS and a group representing retired teachers.) If these other parties were to agree to such

a payment plan, they probably would insist on *even larger* payments from the state over time to compensate for the investment returns that CalSTRS would likely forego as a result of giving up the ability to begin investing the entire interest payment immediately. In short, without the other parties agreeing to the administration's payment plan, the viability of such a measure in the courts is very uncertain. With such an agreement, state costs would likely increase even more in future years.

Recommend Paying Interest in One Lump Sum. Barring an agreement from the other parties to pay the required interest over several years at no additional state cost, we recommend that the Legislature comply with the court order and appropriate funds to pay the entire interest obligation (as well as any court-ordered costs) in the 2008-09 budget or earlier. This would increase General Fund costs over the two-year period of 2007-08 and 2008-09 by over $130 million, compared to the administration's budget plan. This approach, however, limits the potential for any future liabilities from this case.

Recommend That Legislature Again Reject Plan to Guarantee Teacher Benefit

We recommend that the Legislature reject the administration's proposed trailer bill language to (1) guarantee retirees' purchasing power benefits through the California State Teachers' Retirement System (CalSTRS) and (2) reduce General Fund costs by $80 million in 2008-09. There are major risks in assuming that the proposed change will generate budget savings, and we are concerned about the idea of the **state** ***guaranteeing another benefit through CalSTRS, which serves employees of*** **local** ***districts.***

Budget Proposes Changing State Payments and Guaranteeing the Benefit. As the administration proposed one year ago, the Governor's budget again proposes changing the annual SBMA appropriation from 2.5 percent of prior-year teacher payroll to 2.2 percent. The administration proposes amending the law to guarantee CalSTRS members that they will receive the current SBMA benefit: 80 percent of the purchasing power of the retiree's original monthly benefit, as measured by annual inflation increases. Currently, this benefit is not guaranteed and instead must be paid to retirees by CalSTRS only to the extent funds are available in the account. This year's administration proposal, unlike last year's, also proposes that the annual SBMA payments be made in two equal payments on November 1 and April 1 of each year. Currently, the state makes one SBMA payment each year on July 1.

This Year's Proposal Is Less Likely to Be Workable Than Last Year's. Longstanding California case law in the area of public employees' retire-

ment benefits requires that a government's changes in pension benefits resulting in disadvantages to employees be accompanied by "comparable new advantages" for those same employees. In the *Analysis of the 2007-08 Budget Bill* (see page F-68), we discussed some of the legal risks of the administration's earlier SBMA proposal. The Legislature did not approve the administration's proposal, and a payment equal to 2.5 percent of prior-year teacher payroll was paid to CalSTRS' SBMA account in early July under its continuous appropriation (while the Legislature was still deliberating on the *2007-08 Budget Act*.) This year's administration proposal carries greater legal risks. The new advantages to CalSTRS members under the proposal (a guarantee of the current SBMA benefits for the first time) are clear, though not quantifiable in their value. At the same time, the disadvantages to employees (reduction in the state's annual payments and the delay in those payments past July 1, which would diminish CalSTRS' ability to earn investment returns) are substantial and able to be estimated. The addition of the proposal to delay the state's payments, therefore, reduces the chance that the plan would be legally workable. (Statutory changes related to SBMA probably would need to be enacted into law prior to July 1 in order to reduce 2008-09 General Fund costs.)

Proposed Language Could Add State Costs. On January 31, 2008, the administration submitted trailer bill language to implement its proposals. These provisions would give TRB the authority to set the state's contribution rates for SBMA beginning in 2009-10. Based on prior actions of the TRB and statements by CalSTRS' consulting actuaries, this raises the strong possibility that state contribution rates would rise back to 2.5 percent of prior-year payroll *or even higher* after the budget year. As a result, the state could end up paying more each year under the administration's proposal. We will provide additional analysis of these provisions during budget subcommittee hearings.

Legislature Should Pursue Broader Reforms. An actuarial valuation obtained by the administration indicates that the current-law contributions to SBMA may, over time, lead to the account accumulating a significant fund balance. In contrast to the Governor's proposal, we believe that any excess moneys should be used to first shore up the financial condition of the DB Program as part of a comprehensive reform of CalSTRS. We recommend reforms that (1) place clear responsibility on local districts to fund their own teacher retirement benefits in the future and (2) give districts and their teachers and administrators greater flexibility to determine the level of retirement benefits they wish to fund. The administration's proposal, by contrast, means the state would be guaranteeing yet another benefit for local districts' employees. This proposal moves CalSTRS in the wrong direction.

Recommend Rejecting Administration's Proposal to Change SBMA Benefits. Given both the legal risks and our policy concerns, we recommend that the Legislature reject the administration's proposed changes to SBMA benefits. This would increase General Fund costs by $80 million in 2008-09.

Recommend Applying Commission's Independent Performance Audit Recommendation to CalSTRS

The Public Employee Post-Employment Benefits Commission recommends that all public pension plans have periodic performance audits performed by independent auditors. Current law requires the California State Teachers' Retirement System (CalSTRS) to have an independent audit annually, but restricts the ability of the Bureau of State Audits or Department of Finance to review CalSTRS' books and operations. This restriction lacks clarity and could be construed to limit the Legislature's authority to request performance audits of certain CalSTRS programs. Accordingly, we recommend that the Legislature enact a law that repeals or clarifies this restriction.

PEBC Report Contains 34 Recommendations for the State and Local Governments. The Public Employee Post-Employment Benefits Commission (PEBC) report lists 34 recommendations for California state and local policy makers—grouped into eight general categories. The report contains several recommendations to promote independent analyses of pension system operations and transparency for policy makers, system members, and the general public.

Commission Recommends More Independent Audits of Pension Systems. The PEBC recommends that "all public pension plans should have periodic performance audits performed by an independent auditor." Pension systems, including CalSTRS, already are required to hire an outside, independent accounting firm each year to audit their financial records to ensure compliance with generally accepted accounting rules. However, current law, the commissioners conclude, "does not provide for regular performance audits of public retirement systems," which "could look at any aspect of the workings of a retirement system (administrative, investment, or benefit delivery), compare policies to practice, and provide valuable insight into how operations might be improved." We concur with this recommendation.

Current Law Restricts Ability of Legislature to Request Such Audits. Section 22217 of the Education Code requires CalSTRS to have its financial records audited annually by an independent accountant. The law, however, states that "the audits shall not be duplicated by the Department of Finance (DOF) or the State Auditor." In state government, DOF and the

Bureau of State Audits (BSA) are the principal entities that the Legislature may direct to conduct performance audits of government programs. This code section is unclear if these restrictions also apply to DOF and BSA concerning performance audits.

Recommend Repealing or Clarifying Restriction. Accordingly, we recommend repealing or clarifying the law so that DOF and BSA may conduct performance audits on the programs of CalSTRS. This would allow the Legislature, including the Joint Legislative Audit Committee, to request performance audits of CalSTRS without any restrictions, similar to the way that lawmakers may request audits of other state programs.

DEPARTMENT OF REAL ESTATE (2320)

The primary mission of the Department of Real Estate is to protect the public in real estate transactions. It carries out this mission through its licensing, enforcement and recovery, and subdivisions programs. The Licensing program conducts examinations to ensure that individuals who wish to work in the real estate industry meet specific qualifications. The Enforcement and Recovery program conducts compliance audits of licensees and administratively prosecutes violations of the Real Estate Law. The Subdivisions program issues public reports with relevant information on subdivided lands for sale.

The budget proposes total expenditures of $45 million, mostly from the Real Estate Fund, for support of the department in 2008-09. This represents a decrease of $2.4 million, or 5 percent, compared to the current-year level. The decrease primarily reflects adjustments for expiring one-time costs. The budget proposes a staffing level of 336 positions for 2008-09, which is a slight decrease compared to the current year.

Real Estate Fraud Prosecution Trust Fund Program

Current law requires the Legislative Analyst's Office to report annually to the Legislature certain information related to real estate fraud cases in counties that participate in the Real Estate Fraud Prosecution Trust Fund Program. The report must also include information on the types of expenditures made by the law enforcement agencies of those counties.

Background. In 1995, the Legislature enacted Chapter 942, Statutes of 1995 (SB 535, Hughes), which created the Real Estate Fraud Prosecution Trust Fund Program. The program allows counties to establish a fee of up to $2 for certain real estate documents filed with the county to support local law enforcement activities to fight real estate fraud.

Counties that opt into the program are required to deposit any fee revenues into a Real Estate Fraud Prosecution Trust Fund for use by local police, sheriffs, and district attorneys to "deter, investigate, and prosecute real estate fraud crimes." Local law enforcement agencies get 40 percent, and district attorneys get 60 percent of program allocations from the fund. In counties where the district attorney exclusively does the investigation, 100 percent would go to that office.

Recipients of the monies are required to provide an annual report to the county board of supervisors on past-year expenditures, the number of filed complaints of real estate fraud, and program outcomes. Chapter 531, Statutes of 2005 (AB 901, Ridley-Thomas) amended the law to require the county board of supervisors to submit those annual reports to the Legislative Analyst's Office (LAO). It further required the LAO to annually compile the information in the reports and report to the Legislature.

No Reports to LAO Until 2007. In October 2007, our office received reports from Sacramento and Santa Clara Counties. These are the first reports that have been submitted to our office since the enactment of Chapter 531. However, it is our understanding based on anecdotal information that as many as 22 counties may be participating in the program. This suggests that many counties may not be aware of their obligation to report on the program.

Summary of Local Expenditures. In Sacramento and Santa Clara Counties, the Real Estate Fraud Prosecution Trust Fund monies have been used to establish and maintain a real estate fraud unit within their respective district attorney's offices. The units are similar in size and composition: Sacramento has five positions dedicated to its unit, and Santa Clara has six positions. Generally, these units consist of attorneys, investigators, and paralegal staff. In Sacramento, the funds also have been used to establish real estate fraud investigative units within the sheriff and police departments.

Figure 1 shows 2005-06 expenditures for the reporting counties. This is the latest year for which complete data were available. As the figure shows, Sacramento spent $1.3 million and Santa Clara spent $936,000. Of these amounts, about 80 percent was used to cover salaries and benefits and the remaining 20 percent was used for services, supplies, and overhead.

Current law places a 10 percent cap on the amount of fee revenues that can be used for administrative costs. However, we could not determine based on the available information whether the reporting counties complied with this requirement.

Figure 1

Real Estate Fraud Prosecution Trust Fund Expenditures

2005-06
(In Millions)

	Sacramento County	Santa Clara County
Salaries and benefits	$1.0	$0.7
Services, supplies, overhead	0.3	0.2
Totals	**$1.3**	**$0.9**

Summary of Program Statistics. Figure 2 shows the program statistics reported by Sacramento and Santa Clara Counties for fiscal year 2005-06. As the figure shows, these counties reported similar statistics for 2005-06.

Figure 2

Real Estate Fraud Program Statistics

2005-06
(Dollars in Millions)

	Sacramento County	Santa Clara County
Number of cases investigated	121	137
Number of cases filed	15	15
Number of victims in filed cases	25	31
Aggregated monetary loss by victims	$23	$15
Number of convictions	11	16

Recommend Coordination of Local Reporting Procedures. Based on anecdotal information, it is our understanding that as many as 22 counties may be participating in the program. Yet, we have only received reports from two counties. This suggests that many counties are unaware of the statutory reporting requirement. The Legislature may wish to direct the

Department of Real Estate at budget hearings to conduct outreach to the counties regarding this program and reporting requirement.

We would also note that in compiling the information for this report, we encountered a number of issues with the reported data. For example, the counties reported on different fiscal years. Sacramento County provided reports for 2004-05 and 2005-06, while Santa Clara provided reports for 2005-06 and 2006-07. Additionally, some of the program outcomes, such as the number of cases investigated, were defined differently by the reporting counties. These types of data problems can make it very time consuming to reconcile the county reports and provide summary information for all participating counties. More importantly, such problems diminish the quality and usefulness of the data for purposes of county-to-county comparisons and statewide review.

The Legislature may wish to further direct the department to work with the participating law enforcement agencies to develop a standard approach to reporting the data. This likely would improve the quality and comparability of the data, as well as allow for more efficient delivery of the statewide report on activities supported by the Real Estate Fraud Prosecution Trust Fund program.

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, with the assistance of the state Workforce Investment Board (WIB), also administers the federal Workforce Investment Act (WIA) program, which provides employment and training services. Local area WIBs partner with EDD's Job Services program to provide job matching and training services to job seekers and employers.

The Governor's budget proposes expenditures totaling $11.7 billion from all funds for support of EDD in 2008-09. This is an increase of $421 million, or 3.7 percent, above current-year estimated expenditures. The increase is primarily the result of higher estimates of UI and DI benefit payments for the budget year. The budget also proposes $25.4 million from the General Fund in 2008-09, which is a decrease of $5.6 million, 18 percent, compared to the current year. This decrease is primarily the result of the expiration in funding of the Los Angeles County Healthcare Project (LACHP), a five-year federal project in which EDD was required to provide funding for the LACHP to address Los Angeles County's healthcare workforce training needs.

Reprioritizing WIA Discretionary Funds

The* 2008-09 Budget Bill *schedules the proposed expenditure of federal Workforce Investment Act (WIA) discretionary funds within broad categories. We compare proposed expenditures for the budget year with the current year and recommend the redirection of $3.9 million in WIA funds proposed for pre-apprenticeship projects and regional collaboratives to instead offset General Fund costs in the parolee employment

programs. We further recommend the adoption of budget bill language to allocate funds for these specific purposes.

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 the state's total WIA funds (an estimated $321.3 million in 2008-09) are allocated to local Workforce Investment Boards (WIB). The remaining 15 percent of WIA funds ($56.7 million in 2008-09) is available for state discretionary purposes such as administration, statewide initiatives, and competitive grants for employment and training programs. Federal law states that all WIA funds "shall be subject to appropriation by the state Legislature."

Proposal for Discretionary Funds. Figure 1 shows the Governor's expenditure plan for state discretionary WIA funds. As the figure shows, administration and program services total $24 million for 2008-09. These are for ongoing administration of all WIA programs (such as oversight, financial management, and labor market information services). The remaining $32.7 million is proposed for discretionary grants in three program categories scheduled in the budget bill: Growth Industries, Industries with a Statewide Need, and Removing Barriers for Special Needs Populations.

Comparing 2008-09 Budget to the 2007-08 Appropriation. The administration's proposal for the three program categories contains significant changes from the programs and projects that were reviewed and approved by the Legislature during the 2007-08 budget process. The administration's 2008-09 proposal reduces the amount of funds directed to high wage/high skill job training (-$1.3 million), services to long-term unemployed(-$1.6 million), youth grants(-$1.5 million), and parolee services(-$4 million). The budget proposes an additional $0.6 million to regional collaboratives and $0.8 million to incentive grants. Furthermore, the budget proposes a total of $10 million for the at-risk/youthful offender gang prevention initiative (an increase of $7.2 million) and $2.4 million for the pre-apprenticeship Governor's pilot projects.

Pre-Apprenticeship-Governor's Pilot Projects. The budget proposes $2.4 million for pre-apprenticeship Governor's pilot projects. In prior years, WIA discretionary funds have been awarded to similar pre-apprenticeship projects targeting various (1) populations, such as Vietnam War veterans, older workers, youth, and limited English speakers, and (2) industries, such as construction, hotel management, and security. While not an entirely new funding initiative, the pre-apprenticeship program was recently added to the 2007-08 expenditure plan through a notification to the Joint Legisla-

Figure 1

Workforce Investment Act (WIA) State Discretionary Funds

(In Millions)

Budget Bill Schedule/Category	2007-08 Appropriation	Proposed 2008-09	Change
(1) WIA Administration and Program Services	$26.6	$24.0	-$2.6
(2) Growth Industries			
Community colleges WIA coordination	$0.6	$0.6	—
Regional collaboratives	0.6	1.2	$0.6
Incentive grants	0.2	0.2	—
High wage/high skill job training	1.3	—	-1.3
At-risk/youthful offender gang prevention	—	3.0	3.0
Subtotals	($2.7)	($5.0)	($2.3)
(3) Industries With a Statewide Need			
Nurse education initiative	$6.2	$6.2	—
Regional collaboratives	0.3	0.3	—
Nurses/healthcare/construction/logistics	3.1	3.1	—
At-risk/youthful offender gang prevention	—	3.0	$3.0
Pre-apprenticeship Governor's pilot projects	—	2.4	2.4
Subtotals	($9.6)	($15.0)	($5.4)
(4) Removing Barriers for Special Needs Populations			
Parolee services	$6.3	$2.3	-$4.0
Incentive grants	0.5	1.3	0.8
Services to long-term unemployed	1.7	0.1	-1.6
Governor's award for veteran's grants	3.0	3.0	—
Veterans/disabled veterans' employment services	0.7	0.7	—
Department of Education WIA coordination	0.4	0.4	—
Youth grants	2.0	0.5	-1.5
At-risk/youthful offender gang prevention	2.8	4.0	1.2
Low wage earners	0.4	0.4	—
Subtotals	($17.8)	($12.7)	(-$5.1)
Total Proposed Expenditures	**$56.7**	**$56.7**	**—**

tive Budget Committee. At the time this analysis was prepared, the EDD was unable to provide outcome data and evaluations to demonstrate the effectiveness of this program. Moreover, past pre-apprenticeship projects

targeted populations and industries that are typically served by other WIA programs. Therefore, we believe there is insufficient justification for the $2.4 million proposed for pre-apprenticeship Governor's pilot projects.

Regional Collaboratives. The budget also proposes $1.5 million ($1.2 million within Growth Industries and $300,000 within Industries with a Statewide Need) for regional collaboratives. According to EDD, this program funds training projects identified by regional collaboratives of business, labor, private foundations, and other public agencies. As described in the "Employment Development Department" section of our *Analysis of the 2007-08 Budget Bill*, an evaluation found that, generally, these collaboratives showed no significant advantage over other established workforce development entities in providing effective workforce services. Given this weak evaluation, we believe there is insufficient justification for the $1.5 million proposed for regional collaboratives.

Reduction in Funds for Parolee Programs. A share of WIA discretionary funds also provides funding for several parolee employment programs operated by the Department of Corrections and Rehabilitation (CDCR). As described in the "Judicial and Criminal Justice" chapter of our *Analysis of the 2007-08 Budget Bill*, we found that these parolee employment programs have value in reducing recidivism for parolees. Investment in effective parolee employment programs is likely to yield some long-term savings from reduced incarceration. For 2008-09, the budget proposes a total of $8.5 million for CDCR parolee programs, with $2.3 million in WIA funds and $6.2 million in General Fund. This is a decrease of $4 million in WIA funds for CDCR parolee programs from the amount that was appropriated for the current year.

Analyst's Recommendations. Based on our review, we conclude that the pre-apprenticeship pilot projects and regional collaboratives do not have the record of effectiveness demonstrated by parolee employment programs. Therefore, we recommend redirecting a total of $3.9 million—$2.4 million from pre-apprenticeship and $1.5 million from regional collaboratives—in WIA funding to the parolee employment programs in CDCR (Item 5225). This redirection will result in an equal amount of General Fund savings in that item.

Legislative Changes to Discretionary Funds. To the extent that the Legislature wishes to adopt the recommendation to redirect these funds, it will be necessary to adopt budget bill language specifying such allocations from the specific appropriation amounts. Therefore, we further recommend that the Legislature adopt budget bill language specifying that of the WIA discretionary funds available, $6.2 million ($2.3 million proposed plus the redirected $3.9 million) be allocated for parolee services in 2008-09.

Department of Industrial Relations (7350)

The mission of the Department of Industrial Relations (DIR) is to protect the workforce of California, improve working conditions, and enhance opportunities for profitable employment. These responsibilities are carried out through three major programs: the adjudication of workers' compensation disputes; the prevention of industrial injuries and deaths; and the enforcement of laws relating to wages, hours, and working conditions. In addition, the department regulates self-insured workers' compensation insurance plans, provides workers' compensation payments to injured workers of uninsured employers and other special categories of employees, offers conciliation services in labor disputes, and conducts and disseminates labor force research.

The 2008-09 budget includes $67.8 million General Fund for the support of DIR. This is a decrease of $550,000 (0.8 percent) General Fund compared to current-year expenditures.

Proposal to Relocate Headquarters Is Premature

The Governor's budget proposes $432,000 ($130,000 General Fund) in 2008-09 to support the initial planning costs for the ultimate relocation of the Department of Industrial Relations' (DIR's) headquarters office during 2009-10. The purpose of the move is to (1) allow for the expansion of the Administrative Office of the Courts (AOC) and the Department of Justice (DOJ) into existing DIR space and (2) provide additional space for DIR. We recommend rejecting the Governor's proposal because neither AOC nor DOJ has justified the need for an expansion, and we believe that a proposal to authorize DIR to begin relocation activities is premature. (Reduce Item 7350-001-0001 by $130,000 and various special funds by $302,000.)

Background. The DIR headquarters office has been located in the Hiram Johnson State Building (HJSB) in San Francisco since 1999. This space

is shared with AOC and DOJ. The DIR currently occupies approximately 107,400 square feet of office space and houses 475 employees in the HJSB.

Governor's Proposal. The 2008-09 budget proposes $432,000 ($130,000 General Fund) in 2008-09, $3.6 million ($1.1 million General Fund) in 2009-10, and ongoing costs of $6.9 million ($2.1 million General Fund) in 2010-11 to support headquarters office relocation activities for DIR. Specifically, in 2008-09 the funds would be used for planning and leasing activities, in 2009-10 the funds would be used to cover the costs of the move, and beginning in 2010-11 the funds would be used to support an additional 48,000 square feet for DIR's relocated headquarters in San Francisco. The purpose of this proposal is to provide increased space for AOC, DOJ, and DIR.

Governors Proposal Is Premature. The Governor's budget states that the relocation of DIR is necessary for two main reasons—to accommodate the needs of DOJ and AOC and to provide more space for DIR. However, to date, DOJ and AOC have not provided any plan or justification for this expansion. Because all three state agencies share space within the HJSB, it is premature for one department to begin planning for a relocation before the other departments have provided a plan that justifies their need for additional space. Moreover, the budget balancing reductions proposed for all three departments, if adopted, could change staffing levels and result in a less urgent need for new space.

Analyst's Recommendation. Because there is currently no plan in place for the expansion of DOJ and AOC, we find the proposal to authorize DIR to begin planning for a relocation to be premature. We recommend rejection of the Governor's DIR headquarters relocation proposal, resulting in a General Fund savings of $130,000 in 2008-09 and $1.1 million in 2009-10.

DEPARTMENT OF PERSONNEL ADMINISTRATION (8380)

The Department of Personnel Administration (DPA) represents the Governor in negotiations with state employee unions, administers several categories of policies concerning state personnel, and manages certain state employee benefit programs. The Governor's budget includes $15 million of General Fund expenditures for DPA staff and other operations. In addition, the budget includes over $22 million from the General Fund to pay benefits of the Rural Health Care Equity Program (RHCEP), which subsidizes the costs of health benefits for state employees and retirees living in parts of rural California. The Governor subjected most parts of DPA's workload budget to his proposed, across-the-board cuts. Nevertheless, under his proposed budget, total General Fund expenditures for DPA would increase 8.7 percent between 2007-08 and 2008-09 as a result of proposals to:

- Authorize 30 new positions on a two-year limited-term basis—at an annual cost of $3 million—to manage anticipated workload resulting from position reductions and layoffs in other departments. We discuss this proposal below.
- Increase funding for active state employees enrolled in RHCEP in line with anticipated growth of their health premiums.

While the Governor exempts active employees' RHCEP benefits from his proposed budget-balancing reductions, he proposes reducing subsidies for state retirees in RHCEP by 10 percent for a savings of $515,000.

Layoff-Related Workload Will Depend on Budget Plan

When the Legislature approves measures to reduce the size of the workforce in state departments, the workload of the Department of Personnel Administration (DPA) increases—especially to support departments that must initiate the process to lay off some employees. The

Governor proposes $3 million and 30 two-year, limited-term positions for DPA to handle layoff-related workload. We withhold recommendation on this proposal because DPA's staffing requirements will depend on the extent to which the Legislature balances the budget through reductions in the size of departmental workforces.

DPA's Role in the Layoff Process. The Governor proposes the elimination of positions in many departments. Should the Legislature approve the Governor's proposals, some departments will need to initiate a layoff process in order to reduce the size of their workforces. The layoff process—which is complex and can take months for departments to complete—is governed by state law and collective bargaining agreements. The DPA has many responsibilities in this process, including:

- Reviewing departmental layoff plans.
- Calculating seniority credits for each affected employee to determine the order of layoff.
- Reviewing and adjudicating layoff appeals.
- Meeting and conferring with state employee organizations concerning the effects of layoffs and alternatives to layoffs.

Accordingly, if the Legislature decides to reduce the size of the workforce in many state departments as part of its effort to balance the budget, DPA's workload will increase.

The Layoff Process in Recent Years. The state last implemented large numbers of position reductions in 2003-04. According to DPA, 9,300 positions statewide—most of them vacant positions—were eliminated in 2003-04, but only 291 employees lost their job. Another 929 were demoted, transferred, or opted to retire in lieu of a layoff. In that year, DPA increased its staff by 14.5 limited-term positions to manage layoff-related workload. Given the long timeframe required to complete the layoff process, departments sometimes must initiate the formal steps of the layoff process—increasing DPA's workload—even if, in the end, they are able to minimize or eliminate the need for layoffs through attrition or other means.

Withhold Recommendation. We withhold recommendation on the administration's proposal for added DPA staff to handle layoff-related workload. The DPA's staffing requirements in this area will depend on the extent to which the Legislature opts to reduce positions in departments to help balance the budget. Based on the information available to us at the time this publication was written, it appears that the bulk of possible layoffs under the Governor's budget would occur in the Department of Corrections and Rehabilitation (CDCR). Accordingly, the Legislature's actions on CDCR's budget may influence the need to authorize more or less staff for DPA than the Governor proposes.

Financial Information System for California (8880)

This item appropriates funds for the Financial Information System for California (FI$Cal). FI$Cal is an information technology (IT) project managed by a partnership of the Department of Finance (DOF), the State Treasurer's Office (STO), the State Controller's Office (SCO), and the Department of General Services (DGS). The purpose of this project is to create and implement a new statewide financial system.

For FI$Cal, the 2008-09 budget proposes 98 positions and $40.1 million ($2.4 million General Fund, and $37.7 million special funds).

Increasing Legislative Oversight For the Proposed FI$Cal

The* 2008-09 Governor's Budget *proposes to proceed with statewide implementation of the Financial Information System for California at a total cost over a multiyear time frame of $1.6 billion, with a 30-day legislative review period after the initial departments are implemented. We recommend an alternative which limits the initial scope of the project, allows for a more extensive legislative review before proceeding with statewide implementation, results in lower initial expenditures, and reduces the project's reliance on borrowing.

Background: 2007 Project Proposal

Expanding on the New System for DOF. Since 2005, DOF has been working on a project to modernize its existing budget system, known as Budget Information System (BIS). In planning for the development of BIS, DOF came to the conclusion that it made more sense to replace all of the

state's financial and accounting systems, rather than just modernize the one system within its department.

Project Description. In the 2007-08 budget, the Governor proposed an IT project, referred to as FI$Cal, that would take eight years to develop and implement a statewide automated financial system in all state departments, with a total cost of $1.3 billion. The new financial system would encompass budgeting, purchasing, accounting, and cash management. The project effort would be managed by a partnership of the four control agencies responsible for California's financial management: DOF for budgeting, DGS for procurement, SCO for accounts payable and receivable, and STO for cash management. Independent project oversight would be provided by a consulting contractor reporting directly to DOF.

Last Year's Analysis: Project Risks Significant. In the *Analysis of the 2007-08 Budget Bill,* we noted that there are significant risks involved in a project as large as FI$Cal. And, like all such IT projects, these risks must be managed and mitigated. Accordingly, we recommended that increased project oversight be imposed in order to maximize the potential for project success. In addition, we discussed a number of key project components which imposed further project risk including:

- The proposed eight-year project schedule seemed aggressive for implementing more than 100 state entities.
- Redesigning the control agencies' work processes would present major organizational challenges. Therefore, control agency leadership would need to maintain its commitment to the project's high priority and to the required organizational change.
- The funding proposal called for a 100 percent General Fund ($784 million) investment during the first five years with no assurances of federal reimbursement.

Legislative Direction

During the spring 2007 budget hearings, the Legislature acknowledged that the state's financial systems were aging and in need of replacement. However, the FI$Cal project risks were a concern. In the *2007-08 Budget Act*, the Legislature appropriated $6.6 million for FI$Cal and adopted language which required (1) transferring an existing oversight contract to the Bureau of State Audits (BSA) and (2) delivering a series of reports to the Legislature by April 2008 to address various project implementation issues. Key elements of the required reports include:

- ***Alternatives.*** The administration was required to develop alternatives including, but not limited to, a "proof of concept" pilot project, the original BIS project, and no project.
- ***Formalization of Control Agency Roles.*** The four partnering agency sponsors were to formalize their roles through a memorandum of understanding (MOU).
- ***Succession Planning.*** A plan for leadership and project staff succession was to be developed.
- ***Vendor Accountability.*** A plan for managing the vendor and ensuring accountability was to be provided.
- ***Project Oversight and Communication.*** A plan which formalizes the oversight roles of the Office of Technology, Review, Oversight, and Security, and BSA was to be developed along with a plan for how the oversight entities and the vendor would communicate among themselves.

Assessment of the Response to Budget Control Language

In November 2007, DOF submitted a revised special project report (SPR) to the Legislative Analyst's Office (LAO)—five months early. This SPR is generally responsive to the requirements of the budget act. For example, an MOU has been entered into among the control agencies and a detailed process to hold the vendor accountable is documented. However, the alternative project plans required by the budget act came up short in some respects. Figure 1 (see next page) summarizes the alternative FI$Cal plans. One of the alternatives specified by the Legislature to be included in the SPR is a pilot project. The SPR included a proof-of-concept project which on the surface may look like a pilot project, however, as presented in the SPR, this alternative is not viable because it would implement less than 10 percent of the departments for nearly $800 million—one-half of the full FI$Cal cost. Finally, we note that the oversight communication plan, also due in April 2008, has not yet been provided to the Legislature.

Revised Project Proposal

The revised SPR proposes the original project scope to modernize the control agencies' processes and then implements the FI$Cal system in all departments over a schedule that has been extended by two years. The costs have been revised from $1.3 billion to $1.6 billion to reflect the extended schedule. Industry best practices that improve the project's opportunity for success continue to be part of the proposal. These include having knowledgeable state financial staff on the project and conducting

Figure 1

Summary of Administration's Alternative Approaches to FI$Cal

Alternative	Completion Year	Cost
Recommended Approach. Statewide implementation of new financial system in waves. After completion of first wave with control agencies and four departments, there would be a 30-day legislative review period while implementation of additional waves was under way.	2017	$1.6 billion
Alternatives:		
Original FI$Cal Proposal. This would implement a new statewide financial system replacing all existing systems.	2016	$1.3 billion
"Proof of Concept" Pilot Project. This would be the four control agencies plus three program departments. Subsequent statewide rollout would be a separate project.	2021	$784 million
Budget Information System (BIS). This is limited to a new budget system at the Department of Finance (DOF).	2014	$138 million
BIS Plus Accounting. This would implement a new budget system at DOF plus a new statewide accounting system.	2014	$1.2 billion
Do Nothing. This would leave departments to propose projects for replacement of their individual financial systems.	Unknown	$6.2 billion

classroom training prior to putting the system into production. Below we describe the plans for implementation and financing.

Implementation Approach. Under the recommended approach, the first wave of departments will be implemented by 2012. These include the four control agencies (DOF, SCO, DGS, and STO) plus four program departments. The program departments are the Departments of Social Services (DSS), Justice (DOJ), Parks and Recreation (DPR), and the Board of Equalization (BOE). These program departments were selected for their broad representation of different state financial functions. For example, the DSS administers many different federal programs involving block grants and entitlements. The BOE is a revenue-generating department. The DOJ has the same 1970s financial system as BOE. The DPR does capital outlay projects, grant management, and bond financing. Together, these departments will test the system's ability to meet a wide range of public sector financial requirements.

By October 2012, the project would submit a status report to the Legislature for a 30-day review period. At this point, the project will have spent

$490 million and the second wave of 11 departments will be 15 months into their 24-month implementation. Assuming legislative approval, the remaining statewide implementation would continue and be completed over the following five years. This proposal assumes statewide implementation in 2017 at a total estimated cost of $1.6 billion.

Financing Approach. The administration proposes to borrow $1.2 billion of the $1.6 billion total project costs, initially through short-term bond anticipation notes (BANS). The BANs will include "capitalized" interest so as to eliminate debt-service costs until permanent financing is issued in the form of Certificates of Participation (COPs). (Capitalized interest is the practice of borrowing expected future interest payments so as to avoid debt service costs in the short term.) Debt service would begin in 2012-13. Ongoing maintenance and operations costs (M&O), including repayment of the borrowing, are to be funded through cost allocation to the departments.

Debt Repayment by Departments. The administration's fiscal estimates reflect M&O costs of $101 million starting in 2017, after statewide implementation is complete. The repayment schedule estimates that total debt-service payments in 2017 will be $99 million, rising to $142 million in 2020. Departments will be allocated their share of these combined amounts. Currently, departments share in the cost of existing financial systems such as CalSTARS. Savings from not having to pay their share of CalSTARS operations will in part offset the departments' new obligations to pay M&O and debt-service costs for FI$Cal. The amount of any such savings will only be determined after each department is implemented and is not likely to be significant. However, there may be management efficiencies in that better information is available from the new system for analysis.

Cost Allocation Plan and Federal Participation. The administration indicates that the federal government will share in about 18 percent of project costs. However, federal participation will not begin until 2012-13, after the system is operational in the control agencies and Wave 1 departments. This is because the federal government does not participate during the development phase of financial projects such as FI$Cal. In addition to the federal 18 percent share, the administration estimates that the General Fund will cover about 31 percent of project costs, with special funds covering the remaining 51 percent.

Figure 2 (see next page) shows the estimated annual project costs through 2017-18. The first BAN would be issued in June 2009. This BAN would repay a proposed General Fund loan to cover FI$Cal costs during 2008-09 and fund project costs during 2009-10.

Figure 2

FI$Cal: Administration's Recommended Approach Estimated Annual Project Costs

(In Millions)

2008-09	2009-10	2010-11	2011-12	2012-13
$40.1	$82.7	$160.7	$193.5	$241.5
2013-14	**2014-15**	**2015-16**	**2016-17**	**2017-18**
$250.9	$207.4	$183.9	$145.9	$100.8

Assessing the Advantages and Disadvantages of Administration's Approach

Below we assess the advantages and limitations of proceeding now with FI$Cal or a FI$Cal-like IT project.

Benefits of Proceeding Now

Replacing Old Systems in Danger of Failing. Most of the state's financial infrastructure is comprised of individual department systems which were primarily developed in the 1970s and 1980s. Many of these 'legacy' systems are written in programming languages that have been out of use for more than a decade. These systems must be updated regularly for changes to law, policy, or to add new functions—such as direct deposit. Locating programmers skilled in these outdated languages is becoming increasingly difficult. In addition, these older systems are inefficient and labor intensive. Their limitations inhibit the state's ability to meet growing financial reporting requirements. Many departments struggle to close their accounting books within regulatory time frames each year.

Human Capital Risks of Delay. Over the years, the limitations of the state's out-dated financial systems have led state staff to develop external processes and subsystems to supplement these legacy systems. For the most part, these staff are near or at retirement age. These subsystems and processes are largely undocumented. Tapping this knowledge base before it is lost is seen by the administration as an important reason for proceeding now.

Efficiency Gains From Automated Interfaces. FI$Cal will automate the control agencies' processes, many of which still require receipt of hardcopy information. This should introduce efficiencies that result in

savings. In addition, there are several departments that have replaced, or are in the process of replacing, their outdated financial systems. These replacement systems allow automated transmission of data. If the control agencies can receive automated data transmissions from these departments, it will maximize the success and efficiency of these newer systems at departments like the Department of Water Resources (DWR), Department of Technology Services (DTS), California Department of Corrections and Rehabilitation (CDCR), Department of Transportation (Caltrans), and the Administrative Office of the Courts (AOC).

Limitations of Administration's Approach

High Risk Nature of Project. FI$Cal would be one of the most complex and most expensive information technology projects undertaken to date by state government. It is designed to integrate the budgeting, purchasing, accounting, and cash management systems of the State of California and thus involves more than 100 different entities. Each department will have to adjust its business processes to accommodate commercial software that is different than is being used today. During each department's implementation period, which is estimated to span a year, state staff will continue to be responsible for accomplishing their ongoing workload using current processes while at the same time transitioning to new business practices. This will create a significant level of organizational stress. At this stage of the project, there is no absolute assurance of project success. Given the project's complexity, time delays and cost overruns can be expected.

Degree of Financing Is Unprecedented for an IT Project. The FI$Cal proposal to finance the majority of project development costs using BANS and COPs is a departure from the way IT projects have been paid for in the past. It is common practice for the state to borrow for the acquisition of tangible capital assets. Equipment purchases by the state data centers are financed to align their cash flow with their cost recovery schedule. Borrowing is also used for large IT development projects to acquire the hardware and software products needed to implement the system. For FI$Cal, these costs are $83 million of the $1.2 billion that will be financed. The balance of the borrowing, however, would cover staff and contractor salaries in addition to leased facilities and payments to the state data center for processing and telecommunications costs. For past IT projects, these types of costs were funded with pay-as-you-go appropriations.

Typically, debt financing is used to acquire tangible assets such as buildings and equipment, which have an economic value. In essence, this plan finances a less tangible asset, something that has value to the state, but could not be valued as collateral because it would have little or no value to an outsider. The proposed borrowing adds $400 million in debt-

service costs over the life of the project. Although we believe this financing is feasible, it is not necessarily desirable, especially in the magnitude proposed. Given that this is a less tangible capital asset, it is likely that bond buyers would demand a higher interest rate to compensate for the lack of hard collateral that would typically be available when capital assets such as office buildings are financed. The amount of this risk premium is unknown. Finally, we would note that using bond financing increases the cost of project failure because, even if the project is never completed, the bond buyers would need to be repaid with interest.

Impact on Departments. The future cost of maintaining the FI$Cal system would be paid for by allocating its cost to departments based on their share of use. Adding debt repayment costs to the ongoing maintenance cost would increase costs to departments. Using 2017 as an example, departments would be allocated a total of $200 million; $99 million to repay the debt service plus $101 million for the M&O of the system. Of this amount, the federal government would pay 18 percent, while special funds would pay 51 percent and the General Fund would pay 31 percent. To some extent, this cost would be offset by some unknown savings. In order for departments to maintain their program service levels, the Legislature would most likely be asked to appropriate additional funds to cover these FI$Cal costs.

Borrowing Versus Pay-as-You-Go. Given the state's fiscal condition and the need to update the state's financial systems, a reasonable case can be made to finance the first two or three years of project costs. However, by the third or fourth year, it makes sense to use a more balanced approach between borrowing and "pay-as-you-go" appropriations of special funds and General Fund monies. This would reduce the future debt service burden on the state and its departments.

Proposed Legislative Review Period Unworkable. The project plan requires the administration to submit a report to the Legislature that will discuss the status of the project after implementing the new system in the four control agencies and four program departments. The report would share lessons learned and how these lessons will improve the implementation of the project as it goes forward. However, the report is to be delivered to the Legislature in October, when the Legislature is not in session. Presumably, the Legislature already would have had to make a funding decision regarding the project by July as part of final actions on the state budget.

We believe the proposed 30-day review period is unworkable. First, the Legislature will already have had to make a funding decision as noted above. Second, the review mechanism does not allow adequate time for the Legislature to explore fully the project's challenges and accomplish-

ments and make an informed decision regarding whether to continue with statewide implementation. Moreover, during the proposed review and approval period, the next group of departments will already be more than 60 percent complete in their FI$CAL implementation, thus compromising legislative review of the project.

LAO Alternative: Limit Initial Scope and Then Pause for Legislative Approval After Wave 1

Although it is a close call, we believe the benefits of proceeding with FI$Cal at this time outweigh the benefits of canceling the project altogether. If the project were canceled, it would take many years before it could begin to be implemented in the first wave departments. In the meantime, departmental systems will continue to be at risk of failure and some may have to be replaced, reducing the benefits of FI$Cal.

Below we present the key features of an alternative which provides for greater legislative oversight and review, lower initial costs, and less reliance on borrowing.

Key Features of LAO Alternative

Initial Project Scope. The LAO alternative would go forward with the implementation of "Wave 1" departments. Wave 1 develops the FI$Cal system and installs it in the four control agencies (DOF, SCO, DGS, and STO) plus four program departments (DSS, BOE, DOJ, and DPR). We concur with the administration that these program departments are reasonable choices for the first wave because of their broad representation of state financial functions.

Adjust the Schedule. In order to facilitate legislative review and oversight, the project schedule should be adjusted so that the report on the status of Wave 1 implementation would be presented to the Legislature no later than March 1 after implementation.

Pause for Legislative Approval. Rather than the 30-day review period provided in the administration's plan, we recommend that the Legislature decide whether to proceed with full implementation during the regular budget process or through separate legislation. Unlike the administration's proposal, the project would not proceed with activities to prepare additional departments for system installation until the Legislature has reviewed the report and decided to continue the project. The advantage of this approach is twofold, (1) the Legislature has time to conduct a full inquiry about the project status and, (2) departments that will be implemented in

the second phase of the project are not spending project implementation funds until the Legislature has approved the project to continue.

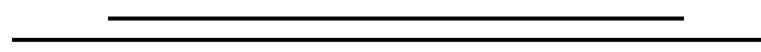
This approach will add a year to the total project schedule because subsequent departments would not begin their one-year preparation until after the Legislature's review. Over the ten-year schedule, this will increase project cost by approximately $67 million, (about $20 million in 2008-09 dollars) compared to the administration's estimates. One might argue that increasing the Legislative review would slow the project down and, therefore, add costs beyond this estimate. We would note that any cost impact could be minimized by (1) adjusting the project schedule to deliver the status report in March instead of October and (2) having the vendor plan for this legislative pause.

Limit Borrowing to $250 Million During the Initial Phase of Development. We estimate the total cost of the first four years of the LAO alternative through Wave 1 implementation to be $461 million. This is $29 million less that the administration's proposal. Given the state's fiscal situation and the need to update the state's financial systems, we recognize a reasonable case can be made to borrow during 2008-09 and 2009-10. However, beginning in 2010-11, we think it makes sense to use a more balanced approach—a combination of additional bond financing and pay-as-you-go appropriations. Bond authority of $250 million represents about 55 percent of estimated Wave 1 project costs. While we see value in replacing the state's aging financial system in the near future, this financing approach will allow adequate time for the administration to set budget priorities that could substantially reduce or even eliminate further borrowing. The Legislature could revisit the issue of additional bond financing, if and when it decides to authorize the remainder of statewide implementation.

Expenditure of Bond Proceeds Subject to Appropriation. In order to increase legislative oversight of funding, we recommend requiring the administration to obtain annual budget act authority to expend bond proceeds.

Analyst's Recommendation

We recommend that the Legislature adopt the LAO Alternative described above. This alternative would enable the control agencies' processes to be modernized and critical system requirements to be tested fully in four diverse departments by 2012. In contrast to the administration's proposal, this alternative would also ensure the Legislature has time to explore fully the project's status in order to determine if continuing implementation is in the state's best interest. In addition, it results in lower initial expenditures and reduces the reliance on borrowing, thereby avoiding future interest costs.



Commission on State Mandates
(8885)

The Commission on State Mandates 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 claims, "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 outstanding noneducation mandate claims incurred prior to 2004-05. The state's backlog of these claims totals over $900 million.

The budget bill provides funding for most noneducation mandates under this item. Funding for one major mental health mandate (Mental Health Services for Special Education Pupils, or the "AB 3632" mandate) is provided under the Department of Mental Health budget. Funding for K-12 and community colleges mandates is provided under their budget items.

Overview

The Governor's budget proposes few policy changes to the list of noneducation mandates local governments must implement. Except for two minor mandates previously scheduled to end, mandates in force in 2007-08 remain in force in 2008-09. Mandates suspended in the current year remain suspended in the budget year.

In terms of mandate funding, the administration proposes two delays. Specifically, the budget bill provides $65.9 million to pay mandate claims from 2005-06 and 2006-07, but no funds to pay claims (1) from 2007-08 or (2) for the Peace Officer Procedural Bill of Rights (POBOR) mandate. The administration indicates that it will pay 2007-08 mandates in 2009-10 (an issue discussed below) and POBOR claims (an employee relations mandate) at an unspecified future date. In terms of the backlog of pre-2004 mandate claims, the budget includes $75 million to make a payment (including interest) towards retiring this debt.

No Funds to Pay 2007-08 Mandate Costs

Under current law (as modified by 2007 trailer legislation), every February local governments estimate their full year's cost to carry out each mandate and submit "estimated cost claims" for reimbursement to the State Controller's Office (SCO). The SCO reviews these estimated claims and reports them to the Legislature and administration in the spring. Funding for estimated claims is included in the annual budget and local governments receive reimbursement shortly after the budget is adopted. The next February, local governments review their prior year estimates and file "actual costs claims." Actual cost claims either (1) verify the amount previously claimed as an estimate, (2) request reimbursement for additional costs, or (3) refund money to the state if the locality's earlier claim was high.

The administration proposes special session legislation to eliminate local government (including K-14 agencies) authority to submit estimated cost claims. Instead, local governments would submit actual cost claims as allowed under current law. The SCO would review these actual cost claims and report them to the administration and Legislature for inclusion in the upcoming budget. Under this schedule, therefore, local governments would receive mandate reimbursements one year later than is currently the case. (For example, local governments would receive payments for mandated activities undertaken in 2007-08 in 2009-10, rather than 2008-09). In terms of noneducation mandates, the state fiscal effect of this proposed change would be a one-time cost shift of $75 million (General Fund) from 2008-09 to 2009-10. In terms of K-14 districts, the state fiscal effect is less clear because the budget bill does not propose resources for K-14 mandates in the budget year.

Analysis. This office has long recommended that the Legislature fund all programs (including mandated programs) in the year in which they are operational. Otherwise, the state may be less likely to consider the fiscal consequences of its actions when making decisions whether to maintain,

repeal, or suspend a program. While statutes previously provided for such a funding time line, for a variety of reasons the Legislature modified the time line last year so that the state pays mandates in the fiscal year after local governments implement them. Thus, the current funding cycle does not have the policy advantage of closely linking policy choices and funding responsibility.

Viewed from this perspective, the question posed by the administration's proposal is whether the benefits associated with an additional year's funding delay outweighs the cost of the funding delay imposed on local governments. In our view, the answer to this question is close, but positive. Deferring mandate payments one additional year would allow SCO to avoid the cumbersome work of reviewing, paying, and filing each local government's annual mandate claim *twice* (as an estimated cost claim and actual cost claim). Because the state has thousands of local governments and dozens of mandates, the SCO annually reviews about 60,000 claims (all submitted in paper files). This workload interferes with other SCO mandate activities, including providing technical assistance, reviewing claims, and developing an automated system for mandate filing. On balance, we believe these benefits outweigh the loss to local governments from less timely reimbursement payments.

ANIMAL ADOPTION MANDATE

Background

Chapter 752, Statutes of 1998 (SB 1785, Hayden), changed state policy regarding shelter care for stray and abandoned animals. Most notably, Chapter 752 (1) declared, "It is the policy of the state that no adoptable animal should be euthanized if it can be adopted into a suitable home," and (2) lengthened the time (generally from three days to six) that shelters must care for animals before euthanizing them.

When the Legislature considered Chapter 752, it was advised that the measure would not impose a state-reimbursable mandate because shelters would receive increased adoption and owner-redemption fees. These fees would offset shelter costs to care for the animals for the longer period.

Shortly after Chapter 752 was enacted, local governments filed a mandate test claim with the commission. The commission found that the cost of caring for the animals that were adopted or reunited with their owners was not a reimbursable mandate (because owners paid fees to offset these costs). In the case of animals that were euthanized, however, the commission found that local government shelters' cost to care for them for three additional days was a state-reimbursable mandate.

Whenever the commission finds a mandate, its next task is to adopt a methodology that local governments use to file reimbursement claims. While mandate law gives the commission flexibility as to the form this methodology takes, the focus must be on reimbursing the specific elements of legislation found to be a mandate, not promoting the legislation's policy objectives.

In the case of this mandate, the commission created a methodology that reimburses local government shelters for (1) their increased cost of caring for the animals that they euthanize and (2) certain minor costs, such as maintaining lost and found lists. In 2008-09, local governments are expected to claim $23 million for this mandate. Almost all of the cost is for the food, medical care, and space needed to keep animals alive for the longer period. Private shelters are not eligible for the mandate reimbursements.

Analysis

Given the state's interest in promoting animal adoptions, we examined whether Chapter 752's longer holding period results in increased adoptions—either directly due to its requirement or indirectly through the mandate funding provided. Our review indicates that there is little reason to believe it does.

Direct Impact of Longer Holding Period. Throughout the United States, there are many more animals in shelters than there are households looking to adopt pets. Partly because of this imbalance between supply and demand, roughly one-half of the animals entering shelters are euthanized. Chapter 752's requirement that shelters keep animals alive longer increases the supply of animals in shelters on any specific day. It also gives animal rescue organizations more time to transfer animals to their facilities. This increased supply of adoptable animals (at shelters and rescue facilities) can give households greater choice in selecting a pet to adopt. It does not necessarily mean, however, that more households adopt pets. That is, the mandate does nothing to increase the demand for these animals.

Indirect Effect of Shelter Funding. To increase the number of pets adopted, more households need to adopt pets rather than buy them from stores or breeders. Especially over the last decade, as concern regarding the treatment of animals has grown, many shelters, animal rescue, and humane groups have taken significant steps towards promoting animal adoption. Does the funding provided under Chapter 752 support these efforts? Our review finds no link between the funding provided under Chapter 752 and programs that encourage animal adoption. Specifically, under the mandate's reimbursement methodology, shelters do not get more state funds if more households adopt animals. Rather, shelters that

euthanize the most animals receive the most state funds. Shelters that are the most successful in promoting adoptions receive the least state funds.

This gap between Chapter 752's policy goals and mandate reimbursements stems from the requirements of mandate law. Specifically, the California Constitution requires the state to reimburse local governments for the cost of required activities—without regard to local success in achieving the desired outcomes

Recommendation

Because the goals of Chapter 752 are not suited to implementation as a mandate, we recommend the Legislature repeal the elements of Chapter 752 that impose a mandate. We further recommend that the state pay the outstanding costs for this mandate over time. (Reduce Item 8885-295-0001 by $13 million and increase Item 8885-299-0001 by $3 million.)

Given mandate law's focus on reimbursing local governments for activities, rather than the achievement of policy objectives, few state objectives are suited to implementation as mandates. This is particularly true when the state seeks to encourage local governments to make significant policy changes, such as in the case of Chapter 752.

Because there is no evidence that the longer holding period (or its mandate funding) furthers state policy objectives, we recommend the Legislature repeal this requirement of Chapter 752 (along with the other minor elements of the measure found to be a mandate). This action would eliminate the state's obligation to reimburse local governments for their increased costs of caring for animals that they euthanize. If the Legislature wishes to give shelters more incentives to promote animal adoptions, we recommend the Legislature try a different approach. For example, the Legislature could pilot an incentive program that gives funding to those shelters that increase the number of animals successfully adopted. (As a point of reference, based on information provided by the Department of Public Health, the state could give local government shelters $30 for every dog or cat adopted for a total annual cost of about $12 million.)

Reduce Funding in Budget for Mandates by $13 Million. The Constitution generally requires the Legislature to (1) pay all outstanding bills for a mandate in the upcoming budget or (2) suspend or repeal the mandate. Repealing the Animal Adoption mandate, therefore, would allow the Legislature to remove funds for it from the budget bill. While the funds for this mandate were not identified specifically in the budget bill, we estimate it to be about $13 million. (This amount represents the outstanding costs for this mandate from 2005-06 and 2006-07.)

Increase Funding in Budget for Prior-Year Mandate Claims by $3 Million. Repealing the Animal Adoption mandate would not eliminate the state's long-term obligation to pay outstanding costs incurred before the repeal. If the Legislature repealed this mandate at the time it enacted the 2008-09 budget, we estimate that it would owe local governments about $36 million for 2005-06 through 2007-08 activities. (That is, $13 million for outstanding 2005-06 and 2006-07 claims and $23 million for 2007-08.) The Constitution does not specify a deadline for payment of these outstanding mandate costs. Given the state's fiscal condition, we recommend the Legislature include resources for outstanding 2005-06 through 2007-08 Animal Adoption claims with the state's payment for the mandate backlog. Under this approach, local governments would be reimbursed for their Animal Adoption mandate costs, with interest, over the next 13 years, at a rate of about $3 million per year.

Summary of Budget Actions. We recommend the Legislature:

- Repeal the requirements of Chapter 752 found to be a state-reimbursable mandate.
- Reduce by $13 million the funds provided in the budget bill for this mandate to pay 2005-06 and 2006-07 mandate claims.
- Increase by $3 million the funds provided in the budget to make a payment for the mandate backlog and prior year Animal Adoption claims.

ANALYSIS OF NEWLY IDENTIFIED MANDATES

We recommend that the Postmortem Examinations: Unidentified Bodies mandate be added to the list of mandates funded in the budget. (Add Examinations: Unidentified Bodies to the list of mandates scheduled under Item 8885-295-0001 [1].)

Chapter 1123, Statutes of 2002 (AB 3000, Committee on Budget), requires the Legislative Analyst's Office to review each mandate included in the commission's annual report of newly identified mandates. This year, the major new mandates pertain to educational programs. We discuss these mandates under our analysis of K-12 education. The only new noneducation mandate reported by the commission was a small mandate totaling $494,000: Postmortem Examinations: Unidentified Bodies.

We raise no policy issues with this criminal justice mandate. To clarify that this mandate should be in force in 2008-09 and allow local governments to receive reimbursements in the budget year, we recommend that this mandate be added to the list of mandates funded in the budget. Based

on the information available at this time, the cost of this small mandate appears to be absorbable within the resources proposed for this item. We will receive additional mandate cost information in the spring and will update the Legislature at that time.

MILITARY DEPARTMENT
(8940)

The Military Department is responsible for the command and management of the California Army and Air National Guard. To support the operations for a force of more than 20,000 personnel, the department maintains a headquarters complex in Sacramento, more than 100 armories, maintenance facilities, training sites, and aviation centers throughout the state.

The mission of the National Guard is to (1) provide mission-ready forces to the federal government, (2) protect the public safety of the citizens of California by providing military support to civil authorities during natural disasters and other emergencies, and (3) provide service and support to local communities in California.

The budget proposes expenditure of $142 million, an increase of 6 percent. Roughly one-half ($73 million) of the overall funding for the department comes from federal funds. Proposed General Fund expenditures are $44 million, about the same as in the current year. The administration proposes a new tuition assistance program for National Guard members and an expansion of wildland firefighting capabilities. We discuss both proposals below.

Tuition Assistance Program Not Justified

We recommend deleting a request for $1.8 million from the General Fund to establish a tuition assistance program for National Guard members. The proposal suffers from several shortcomings. (Reduce Item 8940-001-0001 by $1,819,000.)

Tuition Assistance to Aid Recruiting. The department requests $1.8 million from the General Fund in the budget year to establish a tuition assistance program for National Guard members. Program costs would grow to $3.6 million annually in subsequent years. The department request is based on the idea that a tuition program would help in recruitment and

retention activities. The administration intends to waive the cost of tuition, fees, books, and supplies for National Guard members through a program co-administered by the California Student Aid Commission (CSAC).

CSAC Operated Alternative Program. From 2003 to 2007, CSAC was authorized to administer the National Guard Assumption Program for Loans for Education (NG-APLE). The NG-APLE pays off student loans for qualified students who fulfill terms of enlistment in the National Guard. Due to administrative difficulties, however, the program did not begin to make awards until 2006-07. The program was allowed to sunset on July 1, 2007.

Legislature Has Rejected Other Proposals. The administration previously has made requests for tuition funding outside of the NG-APLE. For instance, the *2007-08 Governor's Budget* included $1.7 million from the General Fund for a tuition assistance program to be run by the Military Department. Similarly, the department has sponsored policy legislation to provide educational assistance in various forms. To date, the Legislature has rejected these proposals due to a variety of concerns. First, the proposed administrative mechanisms tend to be more complicated than the state's APLE programs. This is because programs which provide waivers or grants (such as this year's request), rather than loans, make it difficult for the state to recoup the funds if students fail to complete their military commitment. Second, the proposals have failed to fit within the state's overall financial aid approach which targets assistance to those with demonstrated financial need. The Military's proposals have not provided for a financial needs assessment of recipients. For these reasons, reauthorizing the NG-APLE would be preferable to the administration's approach.

Recommend Rejecting Program. Despite the lack of the tuition assistance programs, the department reports that it has recently improved recruitment—by dedicating additional staff to the efforts. Given this and the concerns noted above, we recommend the Legislature reject the administration's funding proposal for the new program. Furthermore, any proposal for a Military tuition assistance program should first be adopted through the regular legislative process. This would allow the proposal to be fully vetted by the Legislature.

Decision on Helicopters Tied to Surcharge Proposal

We withhold recommendation on a $9 million expansion of the Military Department's wildland firefighting capacity pending the Legislature's key decisions on a new funding source for such costs.

Administration's Insurance Surcharge. As we discuss in more detail in the "Department of Forestry and Fire Protection" writeup in the "Re-

sources" chapter, the administration proposes to authorize a new surcharge on the insurance tax to cover wildland firefighting costs. Through the surcharge, the administration proposes to fund a $9 million expansion of the Military Department's role in wildland firefighting. The funds would be used to purchase $4.8 million in helicopter equipment and hire 36 staff (growing to 43 staff in 2009-10) to provide helicopter support on an around-the-clock basis. The department reports that currently staff are generally available during normal work hours.

Withhold Recommendation. As we discuss in the "Resources" chapter, we recommend that the Legislature adopt an alternative funding mechanism for wildland firefighting costs—a fee on state responsibility area property owners. We withhold recommendation on the Military Department's request until the Legislature makes key decisions on a potential new funding source—including the funding mechanism, the amount to be raised, and the timing of implementation. Once those decisions are made, it will be easier to put the Military's request in context of the state's overall firefighting approach.

Tax Relief
(9100)

The state provides tax relief—both as subventions to local governments and as direct payments to eligible taxpayers—through a number of programs contained within this budget item. The budget proposes $672 million General Fund in tax relief. This represents a modest decline (3 percent) from the $694 million in current-year spending, due to the Governor's budget reduction proposals.

The largest tax relief program is the homeowners' exemption ($443 million), which provides property tax relief to nearly 6 million homeowners. This program, which is required by the State Constitution, grants a $7,000 property tax exemption on the assessed value of owner-occupied dwellings and requires the state to reimburse local governments for the resulting reduction in property tax revenues. The exemption reduces the typical homeowner's taxes by about $75 annually. In order to account for the expected reduction in the number of homeowners claiming the exemption, the Governor's budget proposes a decrease of $4.5 million, or 1 percent, from the amount budgeted for 2007-08. Other tax relief programs include senior citizens' tax assistance programs ($172 million), a senior citizens' property tax deferral program ($23 million), and subventions to local governments for open space preservation ($35 million). We discuss these programs further below.

Recommend Phase-Out of Subventions for Open Space

We recommend that the Legislature enact legislation to stop the state from renewing or entering into new Williamson Act contracts. The program is not a cost-effective land conservation program. (Reduce Item 9100-101-0001 by $3.9 million.)

Background. The Williamson Act allows cities and counties to enter into contracts with landowners to restrict certain property to open space and agricultural uses. In return for these restrictions, the property owners pay reduced property taxes because the land is assessed at a lower-than-

maximum level. The amount of the state subvention to localities is based on the amount and type of land under contract, but is less than the actual reduction in local property tax revenues. The Department of Conservation (DOC), which administers the program, estimates that individual landowners save anywhere from 20 percent to 75 percent in reduced property taxes each year, depending upon their circumstances.

The contracts entered into between local governments and property owners are ten-year contracts. Such contracts are typically renewed each year for an additional year, such that the term on the contract remains at a constant ten years. In the event the contract is not renewed, the tax on the property gradually returns over a ten-year period to the level at which comparable, but unrestricted, land is taxed.

The Administration's Proposal. The administration proposes to delete $3.9 million of General Fund support for Williamson Act subventions—leaving $35 million in funding. This proposal would reduce all subventions by 10 percent in the budget year, while still allowing the program to enter into additional contracts with local governments.

Subventions Not a Cost-Effective Land Conservation Program. In the past, our office has recommended a phased-out elimination of this subventions program (see the *Analysis of the 2004-05 Budget Bill*, pages F-120 through F-122). Our recommendation has been based on our assessment that the act is not a cost-effective land conservation program. In many cases, it may subsidize landowners for behavior they would have taken regardless. The administration's 10 percent reduction of all subventions would provide local governments with less money per contract than they expected when they signed the contracts. In contrast, a gradual phase-out of subventions would provide the promised amount of funds to local governments who entered into Williamson Act contracts, while also stopping the state from incurring any liabilities from new or renewed contracts.

Greater Long-Term Savings. In its first year, our recommendation would provide a similar level of savings as the Governor's budget. Each subsequent year, however, our approach would provide greater savings. By the tenth year, 100 percent of subvention funding ($39 million, assuming current funding levels) would be saved. In addition, DOC's administrative costs to oversee the subvention program—currently $2.1 million from the Soil Conservation Fund—could be gradually reduced over the phase-out period. The administration's proposed trailer bill language would need to be modified to implement our recommendation.

Alternatives to Proposed Changes to Senior Citizens' Property Tax Assistance

We recommend that the Legislature reject the administration's proposal which makes across-the-board cuts to three senior citizen assistance programs. Instead, we recommend that the Legislature (1) maintain existing income thresholds and funding levels in the Senior Citizens' Property Tax Deferral program, and (2) roll back grants in the Senior Citizens' Property Tax Assistance program by 45 percent to 1999-00 levels and institute an income ceiling in the program of $33,000. Together, these changes would result in General Fund savings of approximately $18.5 million in 2008-09. (Reduce Item 9100-101-0001 by $18.5 million.)

Background. There are currently three property tax assistance programs available for eligible senior citizens over the age of 62, the blind, and the disabled. Each of the programs is tied—directly or indirectly—to property taxes paid by participants in the programs.

- ***Senior Citizen Renters' Tax Assistance Program.*** This program provides grants directly to renters in order to offset a portion of the property taxes that are passed on to them in the form of increased rent. In 2007, the program served about 130,000 participants and was limited to those renters with incomes less than $42,770 (this amount is indexed annually for inflation). The amount of assistance provided varies on a sliding scale—with the lowest income renters receiving the most assistance, up to $348 annually.
- ***Senior Citizens' Property Tax Assistance Program.*** This program provides grants directly to homeowners in order to offset a portion of their property tax bill. It has the same income limits as the renters' program. In 2007, the program served about 450,000 participants. As with the renters' program, assistance is provided on a sliding scale—up to $473 annually.
- ***Senior Citizens' Property Tax Deferral Program.*** This program allows homeowners essentially to borrow from the state to pay a portion of their property tax bill. In turn, the state places a lien on the property so that when the property is eventually sold, the state is repaid. The default rate for the program is quite low, with about 99 percent of these types of loans eventually repaid to the state with interest. In 2007, the program was open to individuals with incomes less than $31,500 and served about 8,000 participants.

Recent Program Expansions. All three programs have been significantly expanded in recent years. For the renters' and homeowners' grant assistance programs, Chapter 322, Statutes of 1998 (AB 2797, Cardoza),

increased incomes beginning in 1999-00 from about $13,000 annual household income to about $33,000. These income levels were also required to be indexed based on the cost of living. As part of the 2001-02 budget package, benefit payments were increased by about 45 percent on an ongoing basis. Combined, these tax assistance increases resulted in additional expenditures of more than $175 million annually. The deferral program was recently significantly expanded by Chapter 616, Statutes 2006 (AB 2738, Wyland), which provides for annual increases in the program's income ceiling through 2009-10. Future growth in the income ceilings will be tied to the cost of living beginning in 2010-11.

The Administration's Proposal. The administration proposes several changes in the senior citizens' property tax assistance and deferral programs, resulting in total General Fund savings of $22 million. First, the Governor's budget reduces *all* grants for eligible renters (savings of $15 million) and homeowners ($4 million). In addition, the administration proposes to reduce the income eligibility ceiling for the deferral program from $35,500 to $34,000, resulting in savings of $2.6 million.

Savings Primarily Would Come From Lowest-Income Renters. The administration's proposal reduces all assistance payments by 10 percent regardless of the recipients' financial situation. This across-the-board approach results in some seemingly counterproductive consequences. The bulk of the savings would come from the lowest-income renters. For instance, more than $10 million would come from reduced grants to renters with annual incomes less than $12,000. While an average homeowner with an income of $40,000 would see his or her payment reduced by $2, a renter with an income of $10,000 would have his or her payment reduced by $35.

Any Reductions Should Be More Focused. As an alternative, we recommend that the Legislature focus reductions on the homeowners' grant assistance program rather than the program that provides assistance to renters. While our approach would reduce grants to homeowners, the state's property tax deferral program offers a safety net for low-income homeowners to help ensure they can meet their financial obligations. Such a safety net is unavailable for renters. To preserve the homeowners' safety net, we recommend no changes be made to the deferral program. In order to achieve savings in the homeowners' grant assistance program, the Legislature could roll back the program to its operational level in 1999-00. This change would lower the income ceiling to $33,000 and reduce grant benefits to program participants by 45 percent, resulting in a General Fund savings of $18.5 million in 2008-09 (similar to the total amount of savings proposed by the administration).

Option for Additional Savings. If the Legislature sought additional savings from these programs, it could roll back renters' grants to 1999-00 amounts, perhaps on a more temporary basis. This change would lower the income ceiling to $33,000 and reduce grant benefits to program participants by 45 percent—resulting in an additional General Fund savings of approximately $68 million in the budget year.

HEALTH AND DENTAL BENEFITS FOR ANNUITANTS (9650)

Through this budget item, the state makes most of its contributions toward health and dental insurance premiums of about 220,000 retired state government and California State University (CSU) employees, their family members, and other eligible annuitants. The California Public Employees' Retirement System (CalPERS) administers the health benefit programs for state employees and retirees. Retirees receive a state contribution—the amount of which is set under a statutory formula—of up to 100 percent of monthly premium costs for a health maintenance organization or preferred provider organization plan. The CalPERS health plans require participants to pay for various costs—such as deductibles and prescription drug copayments—"out of pocket."

The administration proposes expenditures of $1.3 billion for retiree benefits in this budget item—an increase of 13 percent over estimated 2007-08 spending levels. Although almost all of these costs are appropriated from the General Fund, the state recovers a portion of the costs—around 40 percent—from (1) special funds through pro rata charges and (2) federal funds through the statewide cost allocation plan.

In addition to the funds appropriated through this item, a portion of state contributions to *active* state employees' health premiums goes to cover some health care costs for retirees (basically, those under age 65). This is because the same premiums are used for both active employees and these pre-Medicare retirees—even though retirees tend to have considerably higher medical costs. Accounting rules refer to these state payments as an "implicit subsidy," which keeps premiums for pre-Medicare retirees lower than they would otherwise be. In 2007, actuaries estimated that the state's implicit subsidy totaled about $300 million per year. In addition to the implicit subsidy, additional state contributions to the health expenses of some retirees living in rural California are paid through the Department of Personnel Administration (DPA) budget, and the university systems also

make additional payments for their retirees' benefits. Combining these amounts together, the state's *total* costs for retiree health and dental benefits in 2008-09 would be in the range of $1.6 billion under the Governor's budget. As described in the text box on the next page, the Governor has exempted retiree health and dental benefits from his proposed across-the-board spending reductions.

Initial Administration Estimates Appear Reasonable

We withhold recommendation on the request for $1.3 billion for retiree health and dental costs pending the California Public Employees' Retirement System's determination of calendar-year 2009 health premiums in May or June. The administration's initial estimates appear reasonable.

Costs Estimated to Continue Growing Rapidly. Under the administration's budget estimate, the state's costs to pay for statutory health and dental benefits for state retirees would continue their recent trend of rapid growth. Figure 1 shows the increases in this budget item since 1999-00—an average annual rate of 15.5 percent. The Governor's budget assumes that the number of retirees eligible for benefits expands by over 3 percent in 2008-09 and that CalPERS adopts an average premium increase of 9.5 percent for its health plans in calendar-year 2009—for a total growth rate in the budget item of about 13 percent. The assumed average rate of premium growth is consistent with that used in the state's actuarial valuation for retiree health and dental benefits, which was released by the State Controller's Office (SCO) in 2007. The SCO's assumptions about annual premium growth were developed in line with a model developed by CalPERS. In general, the administration's estimates appear reasonable. Subsequent adjustments in the budget item will need to account for CalPERS' actions later this year concerning 2009 plan premiums, as well as updated estimates of the state's receipts of subsidies from the federal Medicare Part D program. (In 2007, the Legislature determined that these subsidies would be used to cover a small part of the state's retiree health and dental costs and reduce General Fund costs accordingly.)

Withhold Recommendation. We withhold recommendation on the administration's budget request pending CalPERS' determination of calendar-year 2009 employee and retiree health plan premiums in May or June.

Benefits Exempt From Governor's Proposed Reductions, But Some Savings Options *May* Exist

Governor Cites "Constitutional Restrictions," But the Law Is Uncertain. The Governor exempted retiree health and dental benefits from his proposed across-the-board reductions, citing "constitutional restrictions." State retiree health benefits are set in various statutes, which address the percentage of monthly California Public Employees' Retirement System (CalPERS) plan premium costs that the state pays for eligible annuitants. Some experts believe these payments are a constitutionally guaranteed benefit to retirees. To our knowledge, however, the ability of the state to reduce the percentage of premiums it pays for retirees has never been addressed by a court.

What Would Happen if the Legislature Was Able to Reduce This Budget Item? Reducing the state's contributions to retirees' health and dental plans probably would mean that annuitants (1) would have to pay more for their health and dental benefits and/or (2) would see the scope of their health or dental benefits—for example, the services covered or the quality of service offered by providers—diminished.

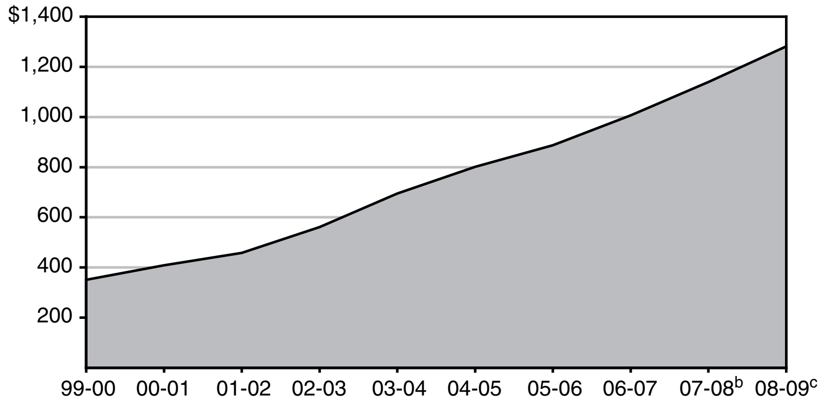
Does the Legislature Have Options to Reduce Costs? The Legislature could amend laws concerning the percentage of premiums the state pays for eligible retirees. In addition, the Legislature could attempt to contain costs without reducing the percentage of premiums paid by the state for retirees. The Legislature, for example, could direct the CalPERS' Board of Administration to increase retirees' out-of-pocket costs beginning in calendar-year 2009 or a future year. Retirees would pay a greater percentage of their overall treatment costs through these out-of-pocket expenses, and the rate of premium growth could be lowered. Paying the percentage of retirees' premiums specified in current law then would be less costly for the state.

Any significant cost reduction measure affecting benefits of existing retirees would probably prompt a legal challenge. Such a challenge could affect the ability of the state to implement cost reductions in a timely manner. With negotiations between CalPERS and health plans for 2009 benefits already underway, the Legislature probably would need to pass a measure to reduce 2008-09 costs well before July 1, 2008.

Figure 1

Retiree Health and Dental Costs Continue Rapid Climb Upward[a]

(All Funds, in Millions)



[a] Does not include implicit subsidies–estimated to be over $300 million in 2007-08–for retiree coverage paid by employer as part of active employees' health premiums.

[b] Estimated.

[c] Budgeted.

The State Should Start Addressing $48 Billion of Unfunded Liabilities for These Benefits

The State Controller's Office released the first actuarial valuation of California's retiree health benefit program in 2007, which estimated the state's unfunded liabilities for these benefits to be $48 billion. We concur with the conclusion reached by a commission appointed by legislative leaders and the Governor: The state should start addressing these liabilities. Otherwise, the liabilities will tend to grow over time—passing to tomorrow's generations the cost of benefits earned by the public employees of today and yesterday.

What Are Unfunded Liabilities and Why Do They Matter? In our publication, *California's First Retiree Health Valuation: Questions and Answers*, we discussed SCO's release of the state's first valuation of its other post-employment benefits (OPEBs)—principally consisting of retiree health benefits—in May 2007. The valuation—completed in accordance with new public-sector accounting rules—identified the state's unfunded actuarial accrued liability (UAAL) for OPEBs to be $48 billion. In simplified terms,

the UAAL is the amount of funds that would need to be set aside today, which, when combined with assumed future investment returns, would be sufficient to cover costs of the retiree benefits *already earned to date* by current and past employees.

Such large UAALs for retiree health benefits have emerged for California, other states, and many local governments because the benefits—unlike pensions—have never been funded in an actuarially sound manner. Instead of setting aside funds to cover the costs of retirement benefits as employees earn them each year—as the state and other governments have done for pension benefits for decades—most governments, including the state, fund retiree health benefits on a "pay-as-you-go" basis. This means benefits are funded only when they are due to the retirees, and no investment earnings are generated to cover a part of the costs. With health costs and the number of public retirees increasing, retiree health costs have grown rapidly over time, as shown in Figure 1. The result of the pay-as-you-go approach is that future generations pay for benefits earned by current and past public employees. This is a violation of a fundamental tenet of public finance: Transfers of costs from one generation to the next should be avoided.

Commission Strongly Recommends That the State Begin Addressing This Issue. Legislative leaders and the Governor appointed a 12-member commission—the Public Employee Post-Employment Benefits Commission (PEBC)—to identify accrued and unfunded OPEB liabilities of the state and local governments and to make recommendations on this topic. (See the nearby text box for more information on PEBC's findings.) Consisting of members of both major political parties (including several leaders of public employee associations), PEBC unanimously recommended that the state and local governments "prefund" retiree health benefits—that is, set aside and invest funds as employees earn OPEB benefits, instead of funding those benefits on a pay-as-you-go basis. "As a policy," the commission recommended, "prefunding OPEB benefits is just as important as prefunding pensions." The "ultimate goal of a prefunding policy," the commission said, "should be to achieve full funding." (Full funding means the elimination of unfunded liabilities over time and the end of intergenerational transfers of benefit costs.) The commission specifically recommended that state policy makers "develop and make public a prefunding plan" and "establish prefunding as both a policy and budget priority." These recommendations are consistent with those in our February 2006 publication, *Retiree Health Care: A Growing Cost For Government*.

At Least $118 Billion of Unfunded State and Local Retiree Health Liabilities

Total Is Even Higher, as Some Governments Have Not Yet Had a Valuation. The Public Employee Post-Employment Benefits Commission (PEBC) was asked to estimate the amount of unfunded retiree health liabilities for the state and all local government entities in California. Based on surveys completed by officials at each level of government, PEBC estimated that the total unfunded retiree health liabilities for the state and local governments were *at least* $118 billion. The figure below displays PEBC's estimates of how the $118 billion is distributed among the various types of governmental entities in the state. The *actual* amount exceeds $118 billion because some governmental entities did not respond to the PEBC survey, and some are not yet required to have completed actuarial valuations under the new public-sector accounting rules. For example, PEBC reported that 53 school districts with annual revenues of over $100 million did not respond to the survey, suggesting that the total amount of unfunded school district liabilities is much higher than listed.

Unfunded Retiree Health Liabilities

(In Billions)

State of California (including CSU)	$47.9
Counties	28.0
School districts	15.9
UC	11.5
Cities	8.8
Special districts	3.5
Community college districts	2.5
Total	**$118.1**

In addition to its own unfunded retiree health liability, the state plays a major role in funding several of the entities shown in the figure—such as the University of California, school districts, and community colleges. As such, the Legislature may face difficult choices in the future for how these governmental entities will pay rising retiree health benefit costs.

Funding the Liabilities Costs Much More Now, but Saves Money Over Time. According to data in SCO's valuation, a full-funding strategy for OPEBs—like that advocated by PEBC and recommended by our office—would require the state to begin setting aside and investing an additional $1.2 billion (in current dollars) each year in a retiree health investment trust fund—similar to the pension funds invested by CalPERS. These estimates assume the state plans to eliminate its OPEB UAAL over 30 years, starts setting aside funds to do so immediately, and consistently funds the trust annually. The estimate—like all actuarial estimates—also assumes that certain assumptions are met each year concerning inflation (including growth of health care premiums) and gains in the stock market. Alternatively, the state could ramp up to the full funding amount of over $1.2 billion over several years and/or pay off its unfunded liabilities over more than 30 years. At some point in the future—likely 20 years from now or more—this strategy would prove to be less expensive than current practice for the state (assuming that future retirees continue to receive the same level of benefits specified in current law). This is because investment returns eventually would fund much or most of the annual benefit costs, relieving cost pressures on the state.

CalPERS' 2008 Premium Increase May Help Reduce Liability Estimate. In June 2007—after SCO's release of the valuation—CalPERS adopted calendar-year 2008 premium increases for its health plans that averaged about 6.3 percent. This was the lowest annual CalPERS premium increase in a decade. The lower-than-expected premium increase resulted in part from CalPERS' decisions to increase copayments and maximum out-of-pocket charges and eliminate certain plan options for some members. The SCO's valuation assumed that 2008 premium increases would average about 10 percent. The CalPERS staff has estimated that the lower 2008 premium increases may reduce the state's unfunded liabilities by over $1 billion in the next valuation. Each year, the unfunded liability will increase or decrease depending on whether the actuaries' assumptions about inflation, investment returns, and other factors are met.

Legislature Also Could Consider Benefit Changes to Address the Liabilities. Another alternative for the Legislature to address the state's unfunded liabilities is to reduce benefits for retirees. This would reduce future retiree benefit costs, but could result in the need to increase some other categories of employee compensation (such as salaries or pension benefits) in order for the state to remain competitive in the labor market.

Administration Suggests a Good First Step to Address OPEB Liabilities. In the *2008-09 Governor's Budget Summary* (see page 241), the administration suggests an alternate approach for addressing OPEB liabilities. Instead of pursuing a full-funding strategy like that recommended by the commission and our office, the strategy discussed in the *Governor's Budget*

Summary seems to involve funding a part of the $1.2 billion (in current dollars) suggested by the SCO's actuaries. As we understand the proposal, this would involve depositing to a retiree health trust account the amount each year estimated by actuaries to be the "normal cost" for OPEB benefits. (This is the amount that, if set aside and invested each year, would be sufficient—with accumulated investment earnings over time—to cover the future costs of the portion of retiree health benefits earned by employees *in that single year*.) As the administration describes it, this amount "would eliminate any new liability from being accrued." Such a funding strategy would be a productive first step for the state in addressing its liabilities, if implemented by the Legislature in the coming years. The administration proposes no change in funding policy for 2008-09.

The *Governor's Budget Summary* also discusses changing current benefit plans to allow greater flexibility and customization. The administration's concept involves meeting directly with unions on the design of the benefit programs. Such a change would be significant, since, currently, the Legislature delegates most such decisions to CalPERS' Board of Administration. Because agreements with unions are subject to legislative approval, the administration's concept may increase legislative authority over the state's employee and retiree benefit programs. We believe the concept is worthy of consideration.

Full Funding Strategy—Not the Administration's—Is the One With the Greatest Benefit. In the *Governor's Budget Summary*, a figure (see page 244) developed in consultation with actuaries claims that, under the administration's suggested funding approach, state costs would be about the same 20 years from now as they would be under either the full-funding strategy or the pay-as-you-go funding strategy. The figure implies that the state's financial condition would be the same over the long term no matter which funding strategy was chosen. We cannot validate the methods and assumptions used by the administration in developing this figure, nor do we agree that the state's long-term fiscal condition will be the same in any event. Projections of this type that are based on actuarial calculations are prone to significant error based on the assumptions utilized concerning caseloads, inflation, investment returns, and other factors. The *full-funding strategy* is the approach that will reduce state costs the most over the long term. The PEBC, actuaries, and our office concur on this fundamental economic fact.

Augmentation for Employee Compensation (9800)

The costs for compensating 350,000 state government, California State University, and University of California employees under existing pay and benefit schedules are included in each department's budget. The Governor's budget assumes these employees' salaries total $23 billion (all funds) in 2008-09. Including employer benefit expenses (principally retirement and health benefit contributions) and payroll taxes, the total costs of compensating these employees are about $30 billion. The General Fund supports more than one-half of this total.

In Item 9800 of the budget act, the Legislature appropriates funds needed to augment departments' budgets in order to fund additional costs for pay and benefits that are expected during the budget year. (Item 9800 addresses increased costs for most state government employees, excluding university, legislative, and some judicial employees.) These additional costs result from:

- Pay and benefit schedules established under memoranda of understanding (MOUs) with state employee unions that are approved and fully funded by the Legislature.
- Pay and benefit schedules for employees (such as managers and supervisors) who are not represented by a union.
- Legislative actions to increase compensation for specific groups of employees independent of the MOU negotiation process with the employee unions.

The Legislature approved $1 billion in spending in Item 9800 in the *2007-08 Budget Act*, but the Governor vetoed $72 million from the General Fund appropriation in the item in an attempt to lower spending. This reduced the overall appropriation to $938 million ($453 million General Fund). Because departmental obligations for increased pay and benefits

under MOUs were unchanged by the veto, this action resulted in many departments—especially the California Department of Corrections and Rehabilitation (CDCR)—having to reduce other categories of budgeted spending and "absorb" the costs of the veto. With the submission of the *2008-09 Governor's Budget* to the Legislature, the administration identified $90 million in unanticipated General Fund savings during 2007-08 in Item 9800. It reduced this amount—in addition to the $72 million veto—from the *2007-08 Budget Act* appropriation.

For 2008-09, the Governor proposes $615 million ($362 million General Fund) for Item 9800. The Governor's plan would result in pay increases for correctional officers, CHP officers, certain health care professionals in departments other than CDCR, and professional engineers. Combined, these groups include roughly one-third of the state government workforce. For the other two-thirds of state workers, there are no funds in the Governor's budget for general salary increases.

BACKGROUND

In general, the amounts in Item 9800 are driven by the requirements of current MOUs with state employee organizations. When the budget act is passed, it includes the estimated amount of funds needed to fulfill existing MOU requirements. New MOUs are approved by the Legislature in statutes, and these measures—if approved by the Legislature after passage of the budget—often include an appropriation to augment the funding included in Item 9800. During the budget year, the Department of Finance (DOF) allocates Item 9800 funding, as needed, to departments to pay the costs of pay and benefit increases.

Since the state began collectively bargaining with its rank-and-file employees in 1982, the annual salary increases for most civil service employees have fluctuated considerably—sometimes being zero when (1) the administration and unions are unable to reach agreement on MOUs or (2) the state faces severe budgetary challenges. Figure 1 (see next page) shows the recent history of general salary increases for the bulk of state civil service workers. During the past several years, three bargaining units—California Highway Patrol (CHP) officers, correctional officers, and professional engineers—have had their salary increases linked to increases in pay of other public-sector workers in the state. Figure 2 (see next page) displays the recent trend of these increases. A few bargaining units, such as the one that includes firefighters in the Department of Forestry and Fire Protection, have received salary increases different from those listed in Figures 1 and 2.

Figure 1

State Civil Service General Salary Increases[a]

1998-99 Through 2008-09

Fiscal Year	Increase	Consumer Price Indices	
		United States	California
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	—	2.2	1.9
2004-05	5.0	3.0	3.3
2005-06	—	3.8	4.3
2006-07	3.5	2.6	3.4
2007-08[b]	3.4	2.9	2.9
2008-09[b]	—[c]	2.7	2.7

a Some bargaining units received salary increases different from those listed here since 2003-04. 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 2.

b Legislative Analyst's Office's estimate of consumer price indices.

c Budgeted.

Figure 2

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

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09 (Budgeted)
Highway Patrol	2.7%	12.1%	5.6%	5.7%[a]	6.1%	4.0%
Correctional Officers	6.8	10.3	8.4[b]	5.2[c]	5.0[d]	—
Professional Engineers	—	5.0	4.0-7.7[e]	7.4-12.4[e]	11.3-14.1[e]	9.2-11.7[e]

a Unit 5 members also received a 3.5 percent stipend beginning in 2006-07 as compensation for pre- and post-shift activities that are compensable under federal law.

b Includes 3.1 percent pay raise—retroactive to 2005-06—awarded to correctional officers as a result of a November 2006 arbitration decision.

c Includes 0.9 percent increase starting June 30, 2006, and a 4.3 percent increase starting July 1, 2006.

d Proposed increase based on administration's "last, best, and final offer" to officers' union.

e Varies by class based on surveys of salaries of engineers employed by California public agencies.

IMPROVED BUDGETING PRACTICES

This Year, Virtually All Funding for Compensation Increases Is In This Item

In the* 2007-08 Budget Act*, the Legislature expressed its intent that virtually all funding for proposed pay and benefit increases be included in this budget item in future years. The* 2008-09 Governor's Budget *appears to comply with this request from the Legislature. In several prior years, the number of individual departmental requests for pay raise funding had proliferated, and this caused the process for considering compensation increases on a comprehensive, statewide basis to break down. The manner in which pay and benefit increases are presented this year has a number of advantages.

Background. The Governor's budget traditionally proposes funding for pay increases in Item 9800. Recent budgets, however, also included requests in departmental budgets to fund additional pay increases. Because some of the departmental requests never went through the ordinary vetting process for pay increases—including review by the Department of Personnel Administration—this practice made the consideration of proposed pay increases chaotic for the Legislature. Legislative staff assigned to analyze employee compensation increases sometimes were not aware of proposed pay increases in departmental budgets until late in the budget process.

New Requirements in 2007-08 Budget. In response to these concerns about the process for considering employee compensation increases, the Legislature adopted new provisional language for Item 9800 in the 2007-08 budget. The provisional language declares the Legislature's intent that proposed budget augmentations for employee compensation increases be budgeted and considered on a comprehensive, statewide basis. Specifically, the language declares legislative intent to reject almost all proposed augmentations for this purpose that are not included in Item 9800 of the *2008-09 Budget Bill*. (The language makes exceptions for employee compensation costs resulting from mandatory judicial orders—potentially including pay increase orders of the Receiver—or bills passed separately from the budget act.) The *2008-09 Budget Bill* includes provisional language in Item 9800 that is essentially identical to the language in the 2007-08 budget.

Advantages of This Year's Budgeting Method. In general, the state plans and budgets compensation increases by bargaining unit—not by department. A key reason for this is that pay raises in an individual department can lead to employees in other departments migrating to work for higher pay. Therefore, the state generally avoids giving raises to employees in one department—but not to similar employees in other

departments—unless there is a compelling need to do so. Item 9800 allows both the administration and the Legislature to consider these factors before approving pay raise funding.

A second advantage relates to estimating errors. During the budget year, DOF allocates funding from this item to each department to cover its identified costs for employee compensation increases. In some years, as in 2006-07, DOF has identified unexpected additional costs for employee compensation, and the Legislature has been able to choose whether to increase funding to departments' budgets for the increased costs. In 2007-08, by contrast, DOF has identified $90 million of unexpected General Fund savings in Item 9800 due to a number of errors in technical assumptions underlying its 2007-08 cost estimate. In our judgment, had these funds for compensation increases been appropriated to departmental budgets—rather than Item 9800—the state probably never would have identified the savings. Placing funds for pay and benefit increases in Item 9800, therefore, promotes accountability and legislative oversight of the budget.

The Legislature Plays the Central Role in Setting Employee Compensation Levels. In *The 2007-08 Budget: Perspectives and Issues* (*P&I*, see page 169), we discussed the Legislature's responsibilities to oversee employee compensation policies. The provisional language for this item in the 2007-08 budget does not affect in any way the Legislature's central role in setting employee pay and benefit levels. If the Legislature wishes to consider an increase of pay or benefits for *any* group of state employees, it has the ability to do so through:

- The regular process of considering proposed MOUs with bargaining units.
- The budget process—by (1) increasing the appropriation in Item 9800 and (2) adopting provisional language directing the administration to implement the compensation increase.
- Passing legislation to address any aspect of state employee compensation policy.

WITH MOST CONTRACTS EXPIRING, THE LEGISLATURE HAS BROAD DISCRETION TO CONTROL EMPLOYEE COSTS

Recommend Targeting Increases to Critical Staffing Problems and Avoiding Multiyear Labor Agreements

Almost all of the state's labor agreements are expiring or already expired this year. We recommend that the Legislature (1) target any increased compensation to employee groups of high-priority programs

with critical staffing problems, (2) reject proposed memoranda of understanding that have a length of more than two years, and (3) consider skeptically all proposals that result in short-term budgetary savings for personnel costs in exchange for higher costs in the future.

No Preexisting Pay Increase Commitments for 90 Percent of Workforce in 2008-09. Of the state's 21 employee bargaining units, only two—the units that include CHP officers and professional engineers—have MOUs that will remain in effect under current law as of the first day of 2008-09. (While the CHP officers' MOU expires in 2010, the state's five-year MOU with the Professional Engineers in California Government [PECG] provides for a pay increase on July 1, 2008 and then expires on July 2, 2008.) The 19 expired or expiring MOUs affect about 90 percent of the rank-and-file state workforce. Excluded workers—those not represented by a union—generally receive pay increases in line with those of the rank-and-file workers they supervise.

What Happens When MOUs Expire? When MOUs expire and no new agreements are approved by the administration, the employee union, and the Legislature, the provisions of the expired MOU generally remain in effect. This means that if an MOU contains a provision specifying, for example, that the state's contribution to employee health benefits rises each January 1, that provision remains in effect even after the MOU has expired—absent a specific legislative action to the contrary. Accordingly, under some existing MOUs, the state may be obligated to increase some categories of compensation—particularly health benefit contributions—after the expiration date. In general, however, MOUs do not contain general salary increases for employees—the costliest category of employee compensation increases—after their expiration dates.

Recommend Targeting Any Increases to Critical Staffing Problems. Given the state's fiscal situation, any dollars allocated for increased employee compensation are likely to be limited. As such, we recommend that the Legislature target any increased compensation to employee groups where there is clear evidence that the raises would address *critical staffing problems*. In our view, critical staffing problems are those affecting (1) departmental programs that provide high-priority public services and (2) groups of employees within the programs where problems in filling positions can *clearly* be attributed to uncompetitive compensation levels. In considering proposed MOUs, the Legislature should ask the administration to provide detailed information on critical staffing problems. Not only should this information address departmental vacancies, attrition, and pay differences between state employees and comparable workers, the information also should discuss the steps that departments have taken or not taken to streamline and expedite their hiring processes. The "target" compensation level for public employees should be the minimum amount

necessary to attract enough qualified labor to fill authorized positions. If departments have hiring and training processes that are so complex and lengthy as to drive away qualified applicants, neither they nor the Legislature can easily determine what this target compensation level even is. By *first* taking actions to improve hiring processes and increase their pool of job applicants, departments can ease somewhat the pressures for increased compensation that otherwise may arise.

Recommend Rejecting MOUs With a Length of More Than Two Years. As discussed in the *2007-08 P&I*, we recommend that the Legislature reject proposed MOUs that have a term of more than two years. Especially given the state's volatile revenue structure and current fiscal problem, we believe that it is not advisable to give an implicit commitment to groups of employees that the state will be able to raise their pay or benefits by a given amount more than one or two years in advance. Shorter-term MOUs give the Legislature more budgeting flexibility, and we believe they represent a firmer commitment to state employees about the level of compensation the state will be able to afford in the future.

Consider Skeptically Proposals for Short-Term Concessions and Longer-Term Costs. In difficult budget years in the past, administrations have proposed budget solutions that involve (1) short-term decreases in employee costs and (2) longer-term increases in these costs. For example, in the *2004-05 Budget Act*, the administration proposed and the Legislature approved the Alternate Retirement Program (ARP). The details of ARP are complex, but generally, it reduces state pension contribution requirements during workers' first two years of state service. For some employees that opt later to receive two years of service credit in the pension system, the ARP then creates an unfunded pension liability, which the state must pay off—with interest—in subsequent decades. There are many different types of short-term budget solutions that involve future increases in employee compensation costs. We recommend that the Legislature review *all* such proposals with skepticism. While these proposals may help address the short-term budget problem, they may complicate the longer-term budget situation and transfer costs for today's public services to future generations of Californians.

Governor's Budget Funds Pay Increases for Correctional Officers, CHP Officers, Engineers, and Health Professionals

In addition to funding salary increases under the labor agreements with California Highway Patrol officers and professional engineers, the Governor's budget would also fund several other categories of increased compensation costs. We recommend that the Legislature reject the proposed compensation increases for (1) correctional officers, an action

that would result in a $491 million reduction in General Fund costs during the current year and the budget year combined, and (2) certain State Controller's Office staff members—for minor savings. We withhold recommendation on the other components of Item 9800 pending a variety of expected technical adjustments by the administration and legislative decisions concerning new memoranda of understanding.

The Governor's Budget Proposal. The Governor's budget includes $615 million ($362 million General Fund), as shown in Figure 3. Included in this amount are the administration's estimated 2008-09 costs for several categories of compensation increases:

Figure 3

Item 9800 Includes $615 Million for Increased Employee Compensation Costs

(In Millions)

	General Fund	Other Funds	Total
General salary increases—California Highway Patrol officers and professional engineers	$9	$198	$207
Proposed labor offer for correctional officers	230	—	230
Compensation increases for health care staff not employed in the prison system	44	—	44
Increased contributions to health, dental, and vision benefits	32	43	75
Various increases resulting from prior contracts	26	12	37
Judges' statutory pay raise	20	—	20
Other	—[a]	—[a]	1
Totals	**$362**	**$253**	**$615**

[a] Amounts less than $500,000.

- General salary increases for CHP officers (estimated at 4 percent) and professional engineers (estimated to be between 9.2 percent and 11.7 percent, depending on the employee classification) pursuant to the bargaining units' existing MOUs—as well as comparable increases for supervisors of these employees and other, related non-represented personnel.
- Pay, health benefit, and other compensation increases for correctional officers and their supervisors—with estimated 2008-09 costs that assume the Legislature approves the Governor's proposals to

(1) impose a labor offer on the California Correctional Peace Officers Association (CCPOA) beginning in 2007-08 and (2) release certain prisoners early, institute a summary parole policy, and reduce the size of the CDCR workforce in 2008-09.

- Pay increases for various groups of health care professionals working in departments other than CDCR—principally the Departments of Developmental Services, Mental Health, and Veterans Affairs—and their supervisors based on:
  - Seven recently proposed MOU addenda affecting *some* employees in Bargaining Unit 4 (office and allied), Unit 16 (physicians and dentists), Unit 17 (registered nurses), Unit 19 (health and social services), and Unit 20 (medical and social services). The approval of these addenda was pending before the Legislature at the time this analysis was prepared.
  - Two MOU addenda that were approved in Chapter 322, Statutes of 2007 (AB 756, Committee on Public Employees, Retirement and Social Security), that affect *some* employees in Bargaining Unit 18 (psychiatric technicians) and Unit 19.
- Increased costs of state contributions to employees' health, dental, and vision benefits pursuant to various MOUs and a proposed MOU addendum with Bargaining Unit 2 (attorneys).
- Increased costs for a variety of pay adjustments—generally targeted to "difficult-to-fill" classifications—described in a number of current MOUs.
- The annual statutory pay increase for judges—the average percentage salary increase in the budget year for state employees—specified in Chapter 102, Statutes of 1981 (AB 251, Vasconcellos).
- Other compensation increases totaling about $1 million, including: (1) a proposal to institute a pay differential to promote staff retention for the Human Resource Management System (HRMS) project, which is administered by the State Controller's Office (SCO), and (2) funding for the state's share of employee costs for the Tahoe Regional Planning Agency (which also receives funding from the State of Nevada).

Below, we discuss our findings and recommendations concerning several of these items.

CHP Officers and Professional Engineers. The state's MOU with the CHP officers' union expires in 2010, and the MOU with PECG expires on July 2, 2008. Under these MOUs, employees receive pay increases in line with those received by comparable workers elsewhere in California's

public sector. Nearly all of the costs of compensating employees in these two bargaining units are paid from special funds, not the General Fund. (The costs for CHP officer salaries are paid largely from the Motor Vehicle Account, while PECG salaries are paid from a number of funds.) While we raise no issue with these proposed pay increases in 2008-09, we reiterate our recommendation in the *2007-08 P&I* for the Legislature to reject future MOUs that include automatic formulas to raise employees' pay in line with increases received by other workers.

Recommend Rejecting Proposed Increases for Correctional Officers. The Governor's budget plan includes the current- and budget-year costs for his proposed 2007-08 compensation increases for correctional officers (including a single 5 percent pay increase retroactive to July 1, 2007). As we discuss in our recent publication, *Correctional Officer Pay, Benefits, and Labor Relations*, we recommend that the Legislature reject the administration's proposed 2007-08 compensation increases for the officers. Our review indicates that the officers' pay and benefits are sufficient, if not more than sufficient, to allow CDCR to meet its current staffing needs. This action would reduce General Fund costs over the two-year period by $491 million below those assumed in the Governor's budget.

The budget assumes that the Legislature approves (1) the proposed CCPOA labor settlement in 2007-08 and (2) significant staffing reductions in CDCR in 2008-09 resulting from the Governor's proposals to release certain prisoners early and institute a summary parole policy. In Item 9800, the Governor's budget assumes $30 million of budget-year savings as a result of CDCR staffing reductions, which would reduce the costs to impose the labor settlement on CCPOA. The $30 million estimate, however, appears to assume that CDCR can reduce its average daily correctional workforce in 2008-09 by over 4,000 positions. As described in the nearby box (see next page), the process that departments undergo to substantially reduce the size of their workforces is lengthy and complex. Accordingly, if the Legislature accepts the Governor's proposal on correctional officer compensation, there is some risk that this $30 million savings will be unachievable in 2008-09 due to delays in the staffing reduction process. Moreover, pursuant to a recent Public Employment Relations Board finding, the administration is seeking to impose a labor settlement on the officers' union "one year at a time," rather than imposing multiple years of the settlement all at once. It is possible, therefore, that the administration will request funding in Item 9800 at a later date for additional pay and benefit increases for correctional officers.

Recommend Rejecting Proposed HRMS Retention Differential. For the second consecutive year, the administration proposes a pay differential—equal to 5 percent of pay—for about 90 employees of SCO's HRMS information technology project at an annual cost of about $550,000.

(Many of the employees are not represented by unions, and therefore, their pay and benefits are considered separately from the collective bargaining process.) The HRMS is the state's new payroll computer system and one of several enterprise resource planning (ERP) projects now underway or being planned within state government. (Another is the administration's proposed Financial Information System for California project.) These ERP projects are complex, requiring years of planning and implementation work, and specialists with ERP expertise reportedly are in high demand in both the public and private sectors. The rationale for the administration's proposal is that ERP staff members should be compensated more than other information technology employees in order to promote retention of staff expertise during the long period in which the project is being implemented. We acknowledge that there may be a reason to provide such increases to some or all state ERP workers, but we recommend the rejec-

The Layoff Process Takes a Long Time in State Government

The Process Can Take Six Months, Nine Months, or More. The State Constitution, state law, and collective bargaining agreements provide many protections to civil service workers, including protections during the layoff process. This layoff process requires a considerable amount of planning by departments, the collection and verification of employee seniority data, review of documents by the Department of Personnel Administration (DPA), meetings with unions to discuss the effects of layoffs and alternatives to layoffs, and weeks or months when employees can question departments' layoff plans and consider other employment or retirement options. In general, the most senior employees are protected from layoffs. The most junior employees are the most likely to be laid off.

History Suggests Layoffs May Total in the Hundreds—Not the Thousands. The number of employees that may need to be laid off will depend on the breadth and scale of position reductions approved by the Legislature. In general, when the Legislature has reduced statewide position counts by thousands of employees in the past, this has resulted in departments laying off only hundreds of workers. For instance, 2003-04 was the last year with significant position reductions. According to DPA, 9,300 positions statewide were eliminated in 2003-04, but only 291 employees lost their job. Departments often minimize the need for layoffs through employee attrition—the rate of which may increase due to the uncertain budget environment—or cutting vacant positions. The administration sometimes negotiates con-

tion of the proposed HRMS pay differential at the present time. This is because the administration has failed to present a comprehensive proposal that addresses and prioritizes the compensation issues facing *all* state ERP workers in all departments. Increasing compensation for employees of only one ERP program creates the risk that this program will lure employees from other important state ERP initiatives. Any future proposal, therefore, should include data (1) on the loss of state ERP workers to other public-sector or private-sector information technology projects and (2) comparing pay and benefits of state ERP workers and ERP workers for other employers.

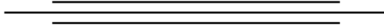
Withhold Recommendation on Other Components of Item 9800. We withhold recommendation on the other components of Item 9800 pending various technical adjustments in the cost estimates, which we expect will be released by the administration at or before the May Revision. By that

cessions from employee unions in order to reduce the need for layoffs. Under certain circumstances, the law also gives the administration powers to take other actions—including voluntary reduced worktime programs and early retirement ("golden handshake") programs—to reduce the need for layoffs.

Early Decisions on Position Reductions May Yield the Most Savings. In order to reduce a significant number of positions, departments may need to initiate the formal layoff planning process—even if, in the end, they lay off no one or only a small number of employees. Because the process is lengthy and complex, the earlier that the Legislature makes decisions to reduce positions, the larger the amount of savings that may be realized during the budget year.

Prison Layoffs Raise Concerns and Would Take Time to Achieve. Under the Governor's budget, it appears that the bulk of layoffs would occur in the California Department of Corrections and Rehabilitation (CDCR). At the direction of the Legislature and the Governor, CDCR recently has focused on increasing its efforts to recruit and hire new employees. Therefore, moving from "hiring mode" to "layoff mode" would be an abrupt change for CDCR. Under the Governor's plan, the department might need to lay off recent graduates of its expanded correctional officers' academy, potentially resulting in the permanent loss of the state's investment to train these employees. If the Legislature substantially reduces positions in CDCR, it should expect these reductions—and the resulting budgetary savings—will take about a year to materialize.

time, the administration may have presented the Legislature with new proposed MOUs for some bargaining units, and the Legislature may have approved or rejected several recently proposed MOU addenda with state health care workers and attorneys.



BUDGET BALANCING REDUCTIONS
(CONTROL SECTION 4.44)

The administration proposes the addition of a new control section to the *2008-09 Budget Bill*. Control Section 4.44 delineates $9.1 billion in General Fund reductions proposed by the administration. Under the section, the administration would have the authority to reduce each department's appropriation by the listed amount.

Any Reductions Should Be Made Directly to Department's Appropriations

To increase transparency of the budget, we recommend that the Legislature delete Control Section 4.44 and integrate any budget reductions that are adopted into specific departmental appropriations. (Delete Control Section 4.44.)

We understand that the administration's Control Section 4.44 proposal was driven largely by workload concerns as the Department of Finance prepared the budget documents prior to their release. By listing all of the reductions in a single control section, the administration avoided having to amend hundreds of lines in the budget bill. Yet, the approach makes the state budget more perplexing to the public than necessary. If an individual opens the proposed budget bill to a particular department (without knowing about the existence of Control Section 4.44), he or she would mistakenly assume that the amounts shown were the intended funding levels. Accurately reading the budget bill under the administration's approach requires looking at a departmental appropriation in conjunction with Control Section 4.44. To increase budget transparency, we recommend that the Legislature delete Control Section 4.44 and integrate any budget reductions that are adopted into specific departmental appropriations.

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Vacant Positions

F-13 ■ **Statewide Vacancy Rate Consistently Has Been About 14 Percent.** According to State Controller's Office (SCO) records, about 14 percent of authorized full-time equivalent employee positions are vacant in the executive branch. Departments will always have some level of vacancies, but vacancies at this high a level are much greater than assumed for most departments during the budget process.

F-15 ■ **Salary Levels Often Are Not the Main Reason for High Vacancy Rates.** Compensation levels sometimes are one factor that makes it difficult for departments to fill positions. Our experience, however, is that *other* factors often are *much more significant* in driving high vacancy levels. These factors include: (1) antiquated and inefficient hiring processes throughout the state's civil service system, (2) departments' usage of budgeted personnel funds to support other expenses that have not been accurately accounted for during the budget process, and (3) departmental responses to cost reduction measures enacted during tough budget years.

F-17 ■ **Recommend Repealing Ineffective Law on Abolishing Vacant Positions.** Recommend the repeal of the existing state law that purports to abolish positions that are vacant for six consecutive months. The law eliminates only a small number of vacant positions and generates significant paperwork in order for departments to avoid abolishing positions. Moreover, the law does not reduce departments' budgets for the small number of vacant positions eliminated.

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F-18 ■ **Options for the Legislature to Address Vacant Positions.** Departments should be held accountable when they do not fill positions that were authorized and funded by the Legislature. In developing a new process for this purpose, the Legislature has several options. In our view, an effective accountability process probably would be labor-intensive for the Legislature, the administration, or other state entities.

F-21 ■ **Broad Legislative Efforts Needed to Simplify, Expedite State Hiring Processes.** Recommend that the Legislature consider broad, systemic civil service reforms like those envisioned by the administration's Human Resources Modernization Project—the details and estimated cost of which have not yet been released.

Secretary for Business, Transportation and Housing

F-26 ■ **Infrastructure State Revolving Fund (ISRF) Scoring Criteria Should Be Modified to Better Target Program Objectives.** Recommend the Legislature enact legislation to provide additional direction to the Infrastructure and Economic Development Bank (I-Bank) on the implementation of the ISRF program. This should include a requirement that projects demonstrate some minimum level economic development and land use benefits in order to be eligible for financing.

F-28 ■ **Additional Staffing Not Justified on a Workload Basis. Reduce Item 0520-001-0649 by $219,000.** Recommend reduction because two positions requested for the Infrastructure State Revolving Fund program are not warranted on a workload basis.

F-29 ■ **Reporting Inadequate to Facilitate Legislative Oversight.** Recommend enactment of legislation to modify I-Bank reporting requirements to include additional program-specific financial information, in order to provide better information for legislative oversight.

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Office of Planning and Research

F-31 ■ **Volunteers Come at High Cost. Reduce Item 0650-001-0001 by $766,000.** Recommend the Legislature delete the proposed funding for the California Volunteer Matching Network program due to the duplicative nature of the program and the costliness of the program per volunteer.

F-33 ■ **Suspend Discretionary Grants. Reduce Item 0650-001-0001 by $5 Million.** Given the state's fiscal situation, we recommend the Legislature suspend the proposed funding for the Cesar Chavez grant program.

Office of Emergency Services

F-34 ■ **Restructure Local Assistance for Public Safety.** Rather than impose across-the-board reductions on local assistance public safety programs, we recommend that the Legislature prioritize program reductions according to programs' objectives, sources of funding, and overall effectiveness. In the "Criminal Justice" chapter, we make various budget-year funding recommendations for the office's public safety programs.

F-x35 ■ **Decision on Fire Engines Tied to Surcharge Proposal.** Withhold recommendation on OES's request for $10 million for wildland firefighting until the Legislature makes key decisions on a potential new funding source—including the funding mechanism, the amount to be raised, and the timing of implementation.

Department of Insurance

F-36 ■ **Budget Provides No Positions for Collection of Special Assessment.** The budget provides no funding or positions for collection of the proposed "special assessment" on commercial and residential fire insurance polices. Should the Legislature adopt the proposal, we recommend that it direct the department to report at budget hearings on the level of resources required, and any other potential issues related to implementation of the proposal.

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California State Lottery Commission

F-39 ■ **Noting Weak Lottery Sales, Governor Proposes Leasing It to Private Entity.** The Governor has proposed leasing the California Lottery to a private concessionaire to improve its sales and generate funds for public purposes. This would require major changes to statutory restrictions on the lottery and, perhaps, approval by voters. A lottery transaction would generate a large up-front payment for the state under the Governor's proposal, as well as other scenarios that do not involve leasing lottery management to private entities.

F-41 ■ **A $37 Billion Up-Front Payment to the State Is Unlikely.** Some have estimated that a lottery transaction could generate up to $37 billion in up-front proceeds for the state. This estimate is unrealistic. The most such a transaction could generate would probably be one-half that amount or less. Such a transaction would mean that some or all lottery profits would no longer be allocated to educational institutions. The resulting decline in education funding could result in new budgetary pressures for the General Fund.

F-42 ■ **Recommend Considering Strategies to Improve the Lottery's Performance.** Recommend that the Legislature continue to explore methods to improve the performance of the Lottery.

California Gambling Control Commission

F-44 ■ **Recommend Suspending Use of Tribal Revenues for Transportation Purposes—$101 Million for the General Fund.** Recommend that the Legislature approve trailer bill language to (1) suspend the use of $101 million of tribal payments to the state to repay transportation loans in 2008-09 and (2) direct that the payments be deposited into the General Fund.

F-46 ■ **Administration Proposal Unnecessarily Deprives General Fund of $40 Million in Revenue. Add Item 0855-111-0367 to authorize a transfer from the Special Distribution Fund (SDF) to the Revenue Sharing Trust Fund (RSTF).** Recommend that the Legislature appropriate funds from the SDF to address the annual RSTF shortfall. The Governor uses General Fund

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revenues for this purpose unnecessarily. This action would increase General Fund revenues by $40 million.

F-49 ■ **Lower Appropriations for Local Casino Grants Will Help the General Fund.** Recommend that the Legislature—before appropriating any new grant funding from the SDF to local governments affected by casinos—approve laws to implement key recommendations from a July 2007 Bureau of State Audits report. Under several recent compacts, tribes negotiate directly with local governments to mitigate environmental and public service effects of casino construction and expansion. Accordingly, in the future, the Legislature should be able to appropriate smaller amounts for the grants. This action will help preserve the solvency of the SDF, thereby reducing fiscal pressures on the General Fund.

F-50 ■ **Withhold Recommendation on All Commission Budget Proposals Pending Review of Reports Due on March 1.** Withhold recommendation on all commission budget proposals pending review of the commission's submissions under the *Supplemental Report of the 2007-08 Budget Act.*

F-51 ■ **More Transparency Needed for General Fund Tribal Compact Revenues.** Recommend that the Legislature direct the administration to display tribal revenues as its own line item in future revenue reports.

Board of Equalization

F-53 ■ **E-Services Deliver a Return on Investment. Reduce Item 0860-001-0001 by $1.4 Million.** Recommend that the Board of Equalization's budget be reduced to account for savings associated with increased use of electronic filing of sales and use tax returns. We also recommend mandatory electronic filing for larger taxpayers to further increase efficiencies.

F-55 ■ **Reduce Audit and Collection Proposals and Score Additional Revenues. Reduce Item 0860-001-0001 by $5.9 Million.** Recommend that the Legislature delete $9.4 million ($5.9 million General Fund) of proposed budget-year spending on sales tax auditors and collectors due to their minimal expected revenue

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benefit. The corresponding net reduction in budget-year revenues would be about $15 million ($10 million General Fund). Our recommendations for the Franchise Tax Board would more than make up for the revenue loss.

Franchise Tax Board

F-60 ■ **Revenue Estimate for Tax Gap Initiative Too Low.** The administration's revenue estimate does not account for all revenues generated by its tax gap proposal. Based on our review, we recommend the Legislature score additional General Fund revenues of $100,000 in 2008-09, and $2.1 million in 2009-10 and annually thereafter.

F-62 ■ **Recommend Additional Efforts to Narrow the Tax Gap. Augment Item 1730-001-0001 by $3.9 Million.** Recommend that the Legislature appropriate $3.9 million to the Franchise Tax Board to fund four additional tax gap enforcement efforts. These funds would generate $58 million in 2008-09 General Fund revenues.

CalPERS—Pension Contributions

F-66 ■ **Budget Assumes Stable Pension Contribution Rates.** Withhold recommendation on 2008-09 California Public Employees' Retirement System (CalPERS) pension contribution rates pending their final determination through the annual actuarial report process. This process typically concludes in May.

F-68 ■ **CalPERS' Inconsistency in Discussing Its Funded Condition May Confuse Policy Makers and Public.** The CalPERS' new method for discussing its unfunded liabilities suggests that its major pension funds have eliminated nearly all of their unfunded liabilities, despite the fact that CalPERS' own method for setting employer pension contribution rates continues to identify large unfunded liabilities. We believe that this inconsistency may confuse policy makers and the public concerning the financial condition of CalPERS' pension funds.

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F-70 ■ **Recommend Applying Commission's Independent Performance Audit Recommendation to CalPERS.** Recommend that the Legislature repeal or clarify a restriction in current law that could be construed to limit the authority of the Bureau of State Audits or the Department of Finance to conduct periodic performance audits of CalPERS programs.

California State Teachers' Retirement System

F-73 ■ **System's Funded Status Improved in Most Recent Valuation.** The most recent California State Teachers' Retirement System (CalSTRS) actuarial valuation reported that the system's unfunded liability declined for a second consecutive year to $19.6 billion in 2006. Measured as a percentage of the system's total liabilities, this unfunded liability is about average among comparable pension systems.

F-74 ■ **Proposal to Delay Court-Ordered Interest Payment Is Risky.** Recommend complying with a court order concerning CalSTRS' purchasing power account by paying the entire court-ordered interest obligation and other court-ordered costs in the *2008-09 Budget Act* or earlier, barring an agreement from the other parties in the case to pay the required interest over several years at no additional state cost. This would increase General Fund costs over the two-year period of 2007-08 and 2008-09 by over $130 million, compared to the administration's plan.

F-75 ■ **Recommend That Legislature Again Reject Plan to Guarantee Teacher Benefit.** Recommend rejecting the administration's proposed trailer bill language to (1) guarantee retirees' purchasing power benefits through CalSTRS and (2) reduce General Fund costs by $80 million in 2008-09. There are major risks in assuming that the proposed change will generate budget savings, and we are concerned about the idea of the *state* guaranteeing another benefit through CalSTRS, which serves employees of *local* districts.

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F-77 ■ **Recommend Applying Commission's Independent Performance Audit Recommendation to CalSTRS.** Recommend that the Legislature repeal or clarify a restriction in current law that could be construed to limit the ability of the Bureau of State Audits or Department of Finance to conduct periodic performance audits of CalSTRS programs.

Department of Real Estate

F-79 ■ **Real Estate Fraud Trust Fund Program.** Recommend the Legislature direct the department at budget hearings to inform participating counties of the reporting requirement, and assist counties in development of a standard approach to reporting program expenditures and outcomes.

Employment Development Department

F-83 ■ **Reprioritizing Workforce Investment Act (WIA) Discretionary Funds.** We provide a comparison of proposed expenditures within the categories to the 2007-08 appropriation and recommend the redirection of $3.9 million WIA funds to offset General Fund costs in parolee employment programs.

Department of Industrial Relations

F-87 ■ **Proposal to Relocate Is Premature. Reduce Item 7350-001-0001 by $130,000 and Various Special Funds by $302,000.** Recommend rejecting the department's premature headquarters relocation proposal.

Department of Personnel Administration

F-89 ■ **Withhold Recommendation on Proposed Staffing to Manage Layoff-Related Workload.** The Department of Personnel Administration's staffing requirements will depend on the extent to which the Legislature balances the budget through reductions in the size of departmental workforces.

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Financial Information System for California

F-91 ■ **Increasing Legislative Oversight for the Proposed Financial Information System for California (FI$Cal).** The *2008-09 Governor's Budget* proposes to proceed with statewide implementation of FI$Cal at a total cost over a multiyear time frame of $1.6 billion, with a 30-day legislative review period after the initial departments are implemented. We recommend an alternative which limits the initial scope of the project, allows for a more extensive legislative review before proceeding with statewide implementation, results in lower initial expenditures, and reduces the project's reliance on bond financing.

Commission on State Mandates

F-103 ■ **Animal Adoption Mandate. Reduce Item 8885-295-0001 by $13 Million and Increase Item 8885-299-0001 by $3 Million.** Because the goals of Chapter 752 are not suited to implementation as a mandate, we recommend the Legislature repeal the Animal Adoption mandate. Recommend the Legislature reduce mandate funding in the budget bill by $13 million and increase funds for payment of prior-year claims by $3 million.

F-106 ■ **Postmortem Examinations: Unidentified Bodies Mandate.** Add mandate to the list of mandates under Item 8885-295-0001 (1). To clarify that this mandate should be in force in 2008-09 and allow local governments to receive reimbursement, this new mandate should be added to the list of mandates funded in the budget.

Military Department

F-108 ■ **Tuition Assistance Not Justified. Reduce Item 8940-001-0001 by $1,819,000.** Recommend rejecting a request for $1.8 million from the General Fund to establish a tuition assistance program for National Guard members. The proposal suffers from several shortcomings.

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F-109 ■ **Decision on Helicopters Tied to Surcharge Proposal.** Withhold recommendation on a $9 million expansion of the department's wildland firefighting capacity pending the Legislature's key decisions on a new funding source for such costs.

Tax Relief

F-111 ■ **Recommend Phase-Out of Subventions for Open Space. Reduce Item 9100-101-0001 by $3.9 Million.** Recommend that the Legislature enact legislation to stop the state from renewing or entering into new Williamson Act contracts. The program is not a cost-effective land conservation program.

F-113 ■ **Recommend Alternatives to Proposed Changes to Senior Citizens' Property Tax Assistance Programs. Reduce Item 9100-101-0001 by $18.5 Million.** Recommend that the Legislature (1) maintain existing income thresholds and funding levels in the property tax deferral and renters' assistance programs, and (2) roll back grants in the Senior Citizens' Property Tax Assistance program by 45 percent to 1999-00 levels and institute an income ceiling in the program of $33,000. Together, these changes would result in General Fund savings of approximately $18.5 million in 2008-09.

Health and Dental Benefits for Annuitants

F-117 ■ **Initial Administration Estimates Appear Reasonable.** Withhold recommendation on the request for $1.3 billion for retiree health and dental costs pending the California Public Employees' Retirement System's determination of calendar-year 2009 health premiums in May or June.

F-119 ■ **The State Should Start Addressing $48 Billion of Unfunded Liabilities for These Benefits.** We concur with the conclusion reached by a commission appointed by legislative leaders and the Governor: The state should start addressing its $48 billion of unfunded retiree health liabilities.

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Augmentation for Employee Compensation

F-127 ■ **This Year, Virtually All Funding for Compensation Increases Is in This Item.** In several prior years, the number of individual departmental requests for pay raise funding had proliferated, and this caused the process for consideraing compensation increases on a comprehensive, statewide basis to break down. The manner in which pay and benefit increases are presented this year has a number of advantages.

F-128 ■ **Recommend Targeting Increases to Critical Staffing Problems and Avoiding Multiyear Labor Agreements.** Recommend that the Legislature (1) target any increased compensation to employee groups of high-priority programs with critical staffing problems, (2) reject proposed memoranda of understanding (MOUs) that have a length of more than two years, and (3) consider skeptically all proposals that result in short-term budgetary savings for personnel costs in exchange for higher costs in the future.

F-130 ■ **Governor's Budget Funds Pay Increases for Correctional Officers, California Highway Patrol Officers, Engineers, and Health Professionals.** Recommend that the Legislature reject proposed pay and benefit increases for (1) correctional officers, an action that would result in a $491 million reduction in General Fund costs during the current year and the budget year combined, and (2) certain State Controller's Office staff members—for minor savings. Withhold recommendation on the other components of Item 9800 pending a variety of expected technical adjustments by the administration and legislative decisions concerning new MOUs.

Budget Balancing Reductions

F-137 ■ **Increase Budget Transparency. Delete Control Section 4.44.** Recommend the Legislature integrate any budget reductions that are adopted into specific departmental appropriations. Having the reductions separate from departmental appropriations is confusing.