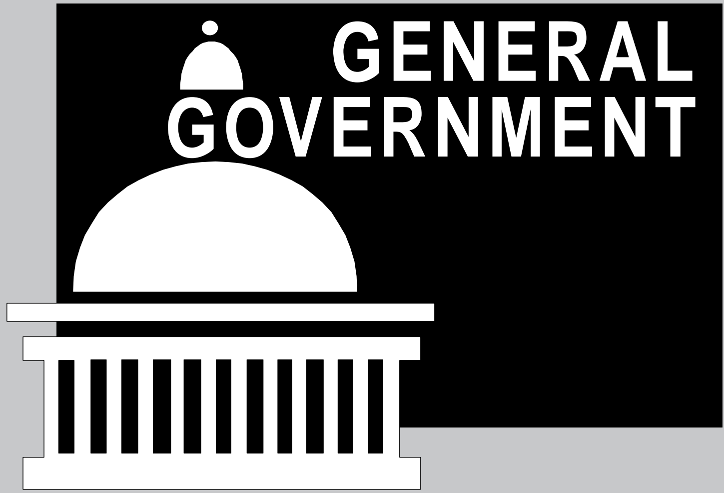

2004-05 Analysis

Major Issues

General Government

Retirement Bond Is Ill-Advised But Other Proposals Merit Consideration

- To reduce budget costs, the administration proposes to issue bonds to finance almost $1 billion in scheduled retirement contributions. A Superior Court has thus far prevented the state from issuing such bonds. Regardless of its legality, incurring decades worth of debt to avoid an annual operating expense is poor fiscal policy. We recommend the Legislature reject the administration's proposal (see page F-17).
- The administration also proposes having current employees contribute more of their salaries to retirement. The idea is worth pursuing in collective bargaining, but the Legislature should be aware of what this provision might cost the state in return (see page F-18).
- For new employees, the administration proposes rolling back retirement benefits to those in place in 1999. We recommend that the Legislature also consider alternatives such as Tier 2 and defined contribution plans for all new employees. These alternatives would result in more state savings and benefits compared to the administration's proposal (see page F-20).

Risky Assumption of $500 Million, But Existing Gaming Revenue Can Help Budget Shortfall

- The budget assumes $500 million in new revenues to the General Fund from the renegotiation of revenue sharing agreements with Indian tribes. The agreements are voluntary and the proposed amount is four times what tribes currently pay. The realization of such revenue in the budget year, therefore, is unlikely (see page F-47).

- The administration does not propose a spending plan for $137 million in the Indian Gaming Special Distribution Fund. We recommend using these funds for gambling-related expenses currently paid by the General Fund, such as public safety and mental health funding for local governments (see page F-49).

Food and Agriculture's Position Management Fails to Provide Adequate Oversight

- The California Department of Food and Agriculture (CDFA) created 500 permanent positions at its own discretion without proper approval. These positions have not been subject to routine administrative and legislative reviews. We make a number of recommendations to ensure appropriate oversight of CDFA's positions (see page F-103).

Budget Fails to Account for Federal Election Funds

- The budget fails to account for more than $250 million in expected federal election reform funds. We recommend that the Secretary of State provide a proposed spending plan, so that the Legislature can determine the best use of the funds (see page F-57).

Contract Savings Overstated

- The budget proposes $100 million ($50 million General Fund) in ongoing savings resulting from the renegotiation of state contracts and leases. This estimate appears unrealistic. We recommend that the administration provide revised savings amounts (see page F-71).

Booking Fees Encourage Efficiencies

- The administration proposes to eliminate $38 million in booking fee relief for local governments, as well as county authority to impose booking fees. Booking fees encourage local agencies to use county booking and detention services more efficiently. We recommend the Legislature reject the administration's proposal to eliminate county authority to impose booking fees, but approve the administration's proposal to end the booking fee relief program (see page F-124).

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OVERVIEW

General Government

Total state funding for general government is proposed to increase by about 26 percent in the budget year. This sizable increase is primarily due to (1) the local government backfill for the vehicle license fee reduction being in effect for the entire budget year and (2) increases in employee compensation and retirement costs.

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, protect consumers, provide services to state agencies, ensure fair employment practices, and collect revenue to fund state operations. The *2004-05 Governor's Budget* proposes $12.5 billion in state funds for these functions. The proposed budget-year funding is $2.6 billion (26 percent) more than estimated 2003-04 expenditures.

SPENDING BY MAJOR PROGRAM

There are three major program areas within general government:

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

We describe these program areas below, and Figure 1 (see next page) shows the estimated 2003-04 and proposed 2004-05 expenditures (combined General Fund and special funds) by program area.

Figure 1

General Government Spending by Program Area

(All Funds, In Millions)

Program	Estimated 2003-04	Proposed 2004-05	Difference
State administration	$2,965	$2,996	$31
Tax relief/local governments	5,791	7,302	1,511
State employee compensation[a]	1,137	2,191	1,054
Totals	**$9,893**	**$12,488**	**$2,595**

Totals may not add due to rounding.

a Costs not reflected in departments' budgets.

State Administration

Within general government, there are about 50 departments and agencies that serve a wide range of functions. Departments provide services to the public, regulate businesses, collect tax revenues, and serve other state entities. For most state departments, the Governor has proposed continuing their level of 2003-04 expenditures in the budget year. Spending is proposed to increase about 1 percent to $3 billion, with General Fund spending declining by 2.4 percent to $1.6 billion.

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. Among the major developments for these departments are:

- The transfer of a number of programs formerly administered by the Office of Criminal Justice Planning (OCJP) to the Office of Emergency Services. The 2003-04 budget eliminated OCJP.
- The proposed elimination of the Office of the Inspector General for Veterans' Affairs, which is responsible for reviewing the state's programs for veterans.
- The Governor's budget continues reductions to the state's economic development and arts programs included in the 2003-04 budget.

Regulatory. Many departments are responsible for providing regulatory oversight of various consumer and business issues. These agencies protect the consumer and promote business development while regu-

lating various aspects of licensee, business, and employment practices. The groups regulated range from individuals licensed to practice different occupations to large corporations licensed to conduct business in the state. Most of these departments are funded from special funds that receive revenues from regulatory and license fees. Among the Governor's proposals in this area are:

- Increased spending of $4.3 million (various special funds) in the Departments of Financial Institutions and Corporations to implement the provisions of recent financial privacy legislation (Chapter 241, Statutes of 2003 [SB 1, Speier]).
- The continued shift of the costs of administering the workers' compensation system from the General Fund to industry assessments.

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 $685 million ($636 million General Fund) for these two agencies in 2004-05, up roughly $9 million (1.4 percent) from the current year.

Services to Other Departments. Some state departments exist primarily to provide support for other departments. For instance, the Department of General Services provides guidance to state departments on purchasing and real estate decisions. The Department of Finance acts as the state's fiscal oversight agency. The Stephen P. Teale and Health and Human Services Data Centers provide most state departments with computer services. As a part of the 2003-04 budget plan, these two data centers are scheduled to consolidate their operations beginning in 2004-05.

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 state makes additional payments to local governments for the distribution of state-collected revenue (primarily from the vehicle license fee [VLF] and gas tax) and to provide funding for specified programs. The Governor's budget proposes to increase General Fund payments in this area from $3.7 billion to $5.0 billion (an increase of 36 per-

cent). This sizable increase is due to increased local subventions related to the VLF reduction, as discussed below. The Governor's proposal to shift $1.3 billion in property taxes from local governments to school districts is reflected in the education section of the budget. (Please see our discussion of this proposal in Part V of the *Perspectives and Issues*.)

VLF Reduction. The VLF is an annual fee levied on the depreciated value of registered vehicles in the state, with revenues going to cities and counties. Beginning in 1999, the Legislature reduced the VLF rate from 2 percent down to 0.65 percent, with a General Fund backfill compensating local governments for the reduced VLF revenues. Actions by the previous administration reversed these VLF reductions for 2003-04 and reduced the corresponding VLF backfill. Subsequent actions by the current administration restored the VLF reductions—as well as the General Fund backfill—for 2003-04 (partial year) and 2004-05. The budget calls for General Fund backfill payments of $4.1 billion—an amount equal to the full VLF reduction.

State Employment and Retirement

Revised Employment Agreements. There are about 167,000 rank-and-file state employees (not including those in higher education) covered under state collective bargaining law. The pay, benefits, and working conditions for these employees are typically spelled out in memoranda of understanding.

In order to generate budget savings in 2003-04, the Legislature approved administration-negotiated agreements for 14 of the state's 21 bargaining units. These agreements deferred scheduled July 1, 2003 salary increases in exchange for additional benefits. In particular, the administration agreed to (1) pay 80 percent of health insurance costs effective January 1, 2004; (2) allow employees to accrue one additional vacation day per month (approximately equivalent to the deferred 5 percent salary increase for most employees); and (3) in some cases, continue the suspension of employees' retirement contributions to maintain take-home pay at current levels. These agreements (and similar arrangements with related exempt employees) will generate an estimated net savings of $391 million ($160 million General Fund) in 2003-04, but increase costs by $517 million ($210 General Fund) in the budget year.

Funding Proposed for Increased Costs. The proposed budget proposes to appropriate $875 million ($464 million General Fund) to fund these revised agreements, as well as the budget-year costs of multiyear agreements with the California Highway Patrol and California Correctional Peace Officers Association (total costs of $295 million, of which $247 million is from the General Fund).

Retirement Payments. The state contributes to the retirement for (1) all state employees through the Public Employees' Retirement System (PERS) and (2) public school teachers through the State Teachers' Retirement System. Retirement-related expenditures (from the General Fund and various special funds) account for a significant part of state spending on an annual basis. In 2004-05, General Fund expenditures for public employee retirement-related costs (excluding University of California costs) will total almost $4 billion, as shown in Figure 2. As discussed below, the Governor proposes to fund over $900 million of this amount through the issuance of a pension obligation bond.

Figure 2

General Fund Costs for Retirement Programs[a]

(In Millions)

	Estimated 2003-04	Proposed 2004-05
State Retirement Plans		
Public Employees' Retirement	$1,217	$1,410
State Teachers' Retirement	510	1,057
Judges' Retirement	122	147
Defined Contribution Plans[b]	44	44
Subtotals	($1,893)	($2,658)
Other Retirement Benefits		
Health and Dental Benefits for Annuitants	$703	$856
Social Security and Medicare[c]	369	398
Subtotals	($1,072)	($1,254)
Totals	**$2,965**	**$3,912**
Proposed Pension Bond Savings	—	-929
Net General Fund Cost	**$2,965**	**$2,983**

a Excludes costs for University of California employees.

b State's contribution to supplemental retirement plan for correctional officers and their supervisors and managers.

c Legislative Analyst's Office estimates.

Governor's Retirement Proposal. The administration is proposing major changes in retirement payments, for an estimated General Fund benefit of $950 million in 2004-05. The major components are:

- Issuing a pension obligation bond to cover a portion of the state's contributions to PERS—generating $929 million in 2004-05 General Fund savings. The 2003-04 budget included plans for a $1.9 billion bond, but a recent Superior Court decision ruled that the state cannot sell these types of bonds without voter approval.
- Increasing the percentage of salary that state employees contribute to retirement. The budget assumes $14 million in General Fund savings from increasing employee contributions by 1 percent. This would require renegotiating with the state's collective bargaining units.
- Rolling back retirement benefits for new employees to those in place prior to Chapter 555, Statutes of 1999 (SB 400, Ortiz). This would generate long-term savings as more employees are hired, but only an estimated $6 million in General Fund savings in 2004-05.

Please see the discussion of this retirement proposal in the "Crosscutting Issues" section of this chapter.

Health and Dental Premiums. The budget also includes $856 million from the General Fund to pay the state share of health and dental insurance premiums for retired state employees and their qualifying beneficiaries. This is an increase of $153 million (22 percent) from estimated current-year expenditures, largely due to continued double-digit growth in health insurance premiums.

CROSSCUTTING ISSUES

General Government

ALTERNATIVE RETIREMENT BENEFIT PROGRAMS

BACKGROUND

State Currently Has "Defined Benefit" Plans

Six Retirement Plans. The Public Employees' Retirement System (PERS) administers the principal retirement plans for state employees. Employees are divided among six retirement classifications based on type of work. Figure 1 (see next page) shows these classifications and the standard retirement benefit for each plan. Correctional officers, firefighters, and highway patrol members have more generous retirement plans than most state employees who are in the Miscellaneous classification.

"Defined Benefits." The state's PERS plans are known as defined benefit programs. Upon retirement, employees receive a set amount of benefits based on a formula that includes age and salary at retirement and the number of years of service. These benefits are lifetime annuities, in that the retiree receives benefits until death. These retirement benefits are not "portable" for those who leave state service (except when they go to other public sector entities in California with reciprocity agreements with PERS). That is, retirement credits must stay with the state, unless an employee opts to "cash out" retirement contributions upon leaving state service. Only the member's contributions (and accumulated interest) can be cashed out. The state's contributions toward retirement are "lost" to an employee who cashes out.

Figure 1

State Retirement Plans

Plans	Basic Benefit[a] Per Year Of Service[b]	Basic Benefit[a] When Retiring at Age	Employee Contribution[c]	2003-04 State Contribution
Miscellaneous:				
Tier 1	2.0%	55	5%	14.8%
Tier 2	1.25	65	—	10.3
Industrial	2.0	55	5	11.1
Safety	2.5	55	6	21.9
Peace Officer/ Firefighter	3.0	55	8	20.3
Highway Patrol	3.0	50	8	32.7

[a] Benefits vary by age, with smaller percentages at younger ages and higher percentages at ages above those listed in some cases.

[b] Percent of highest salary for 12 consecutive months.

[c] Pursuant to collective bargaining agreements, some employees at the present time pay none or only a portion of the amount shown.

State Year-to-Year Costs Have Fluctuated Dramatically

Employee and Employer Contributions. Employees contribute to their retirement through a specified percentage deduction from pretax salary. This amount is fixed and does not vary from one year to the next (unless changed by the collective bargaining process). As shown in Figure 1, employees in the more generous plans have higher contribution rates. The state makes up the difference in contributions required to pay for the guaranteed benefit. As a result, state contributions vary from year to year. The state's contribution rate is made up of two components: (1) the "normal cost," which reflects the annual cost of that year's service and (2) the "unfunded liability," which reflects any shortfall in funding from prior years. The total cost to the state can fluctuate significantly. Figure 2 shows how state employer contribution rates have changed since the 1990s for the different retirement classifications.

Poor Stock Market, Benefits Increase Source of Higher Rates. As shown in Figure 3 (see page 16), PERS estimates that 2004-05 state employer retirement contributions will be $2.6 billion ($1.4 billion General Fund)—just four years after being less than $200 million in 2000-01. This recent growth in state retirement costs is largely attributable to two factors:

Figure 2

State Employer Retirement Contribution Rates

Fiscal Year	Misc. Tier 1	Misc. Tier 2	Industrial	Safety	Peace Officer/ Firefighter	Highway Patrol
1991-92	11.8%	4.0%	13.4%	17.4%	17.4%	21.7%
1992-93	10.3	3.4	12.0	15.7	15.6	17.1
1993-94	9.9	5.0	11.8	15.5	15.2	16.9
1994-95	9.9	5.9	10.6	13.9	12.8	15.6
1995-96	12.4	8.3	9.0	14.2	14.4	14.8
1996-97	13.1	9.3	9.3	14.7	15.4	15.9
1997-98	12.7	9.8	9.0	13.8	15.3	15.5
1998-99	8.5	6.4	4.6	9.4	9.6	13.5
1999-00	1.5	—	—	7.5	—	13.3
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[a]	16.5	11.9	13.1	23.4	23.2	35.4

[a] Public Employees' Retirement System estimates.

- ***Poor Performance of the Stock Market.*** When investment returns are less than assumed, rates go up. Significantly worse returns than expected for three consecutive years beginning in 2000-01 have resulted in rapidly increasing state costs.
- ***Enhanced Retirement Benefits.*** The enhanced retirement benefits resulting from the enactment of Chapter 555, Statutes of 1999 (SB 400, Ortiz), are also a significant factor in the higher rates. Chapter 555 increased benefits by lowering retirement ages, increasing the percent of salary paid in retirement, and basing benefits on the one-year period of highest salary instead of an average of three years. In addition, for highway patrol and correctional officers, Chapter 555 raised the cap on the portion of salary that can be received in retirement from 85 percent to 90 percent. Chapter 555 also closed the state's "Miscellaneous, Tier 2" system to new employees (unless specifically chosen by the employee). Based on PERS data, we estimate that these additional benefits add approximately $600 million to anticipated 2004-05 costs—almost one-quarter of the state's total payment.

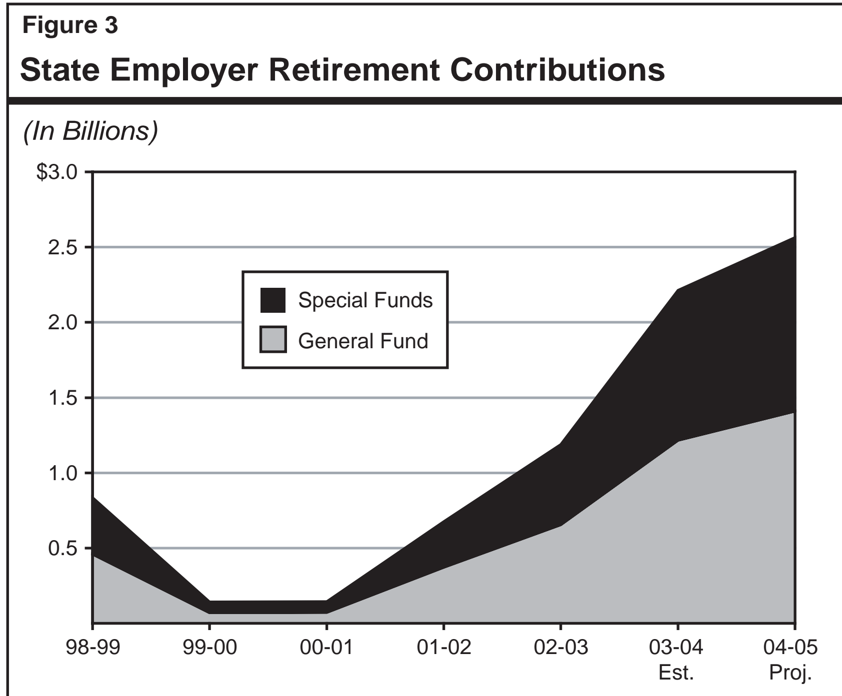


Figure 3

State Employer Retirement Contributions

Cycle Can Make Hard Fiscal Times Even Tougher. This cyclical nature of retirement costs can unfortunately track with state finances in a perverse way, as demonstrated in recent years. When the state had budget surpluses in the late 1990s, retirement contributions fell to very low levels. At that time, however, the state could have more easily covered the current, high retirement costs. As the state budget situation began to deteriorate in 2001-02, retirement contributions started on their upward spiral.

GOVERNOR'S RETIREMENT PROPOSAL

Budget Proposal. The Governor's budget has three retirement-related proposals:

- A pension obligation bond to pay a portion of 2004-05 retirement contributions.
- A 1 percent increase in employee contributions from current state workers.

- Enrolling new employees in the retirement plans in effect prior to Chapter 555's benefits increase, including Tier 2 for new Miscellaneous employees.

Combining the impact of additional employee contributions, state contribution savings from pre-Chapter 555 plans, and pension obligation bond proceeds and debt payments, the Governor's budget estimates the General Fund retirement cost savings shown in Figure 4 through 2009-10.

Figure 4

Administration Estimate of General Fund Savings From Proposed Retirement Reforms

(In Millions)

	Higher Contributions, Current Employees	Benefit Changes, New Employees	Pension Bond Proceeds	Pension Bond Debt Service[a]	Net Savings
2004-05	$13.9	$6.4	$929.4	—	$949.7
2005-06	19.2	17.1	19.5	$(55.8)	—
2006-07	27.8	35.7	—	(57.0)	6.5
2007-08	43.9	72.3	—	(57.0)	59.2
2008-09	41.5	82.2	—	(57.0)	66.7
2009-10	39.6	149.2	—	(98.0)	90.8

[a] Debt service payments would continue at roughly $100 million annually through 2023-24.

Pension Obligation Bond

We recommend that the Legislature reject a pension obligation bond to pay 2004-05 state retirement contributions. Courts have thus far prevented the state from issuing such bonds. Irrespective of legal issues, incurring two decades worth of debt to avoid an annual operating expense is poor fiscal policy.

The Governor's retirement proposal includes a pension obligation bond to pay a portion of the state's 2004-05 retirement contributions to PERS. This would benefit the General Fund by an estimated $929 million in the budget year and $20 million in 2005-06 (to cover some debt-service costs). The bonds would be paid off from the General Fund, with an estimated four years of interest-only payments between $55 million and $60 million, followed by interest and principal payments of roughly $100 million annually for 15 years (see Figure 4).

Lack of Voter Approval Makes Court Certification Unclear. The 2003-04 budget package included a similar pension obligation bond proposal (although it totaled $1.9 billion). In last year's *Analysis* (please see pages F-14 through F-16), we noted that pension obligation bonds had not previously been used to pay a government's annual retirement contributions—an ongoing operating expense. Rather, local governments had used these bonds to pay off unfunded liabilities—a preexisting obligation. For local government bonds, courts had concluded that these general obligation bonds were exempt from voter approval requirements since no new debt was incurred. During the fall, a Superior Court decision invalidated the state's 2003-04 pension obligation bond proposal because it lacked voter approval. The state is currently appealing this decision.

Despite the fact that the administration is concurrently proposing retirement changes, the pension obligation bond proposed for 2004-05 appears nearly identical to the one invalidated by the Superior Court. The bonds are proposed to be sold without voter approval, which is the grounds on which the court disqualified the current-year bonds. Thus, it is unclear to us whether the court would validate this new proposal.

Incurring Debt for Operating Costs Is Ill-Advised. Even if the state could legally implement the Governor's proposal, we believe that incurring two decades worth of debt to avoid a 2004-05 operating expense is poor fiscal policy. Current operating expenses should be paid with current revenues. Paying off the bonds for the one-time benefit in 2004-05 would leave fewer funds for state priorities in the future.

Recommend Rejecting Pension Bond. For these reasons, we recommend that the Legislature reject the pension obligation bond proposal to pay 2004-05 state retirement contributions.

Higher Contributions From Current Employees

Gaining higher retirement contributions from current employees is an idea worth pursuing in collective bargaining. The Legislature should be aware, however, of what this provision might cost the state in return.

The budget proposes increasing contributions into the retirement system from current employees. For most employees, the proposal would raise pretax deductions from 5 percent to 6 percent of salary. The employee contribution for correctional officers, state firefighters, and highway patrol officers would increase from 8 percent to 9 percent.

Additional Contributions Would Require Agreement of Unions. State collective bargaining contracts specify employee retirement contribution provisions. Consequently, this proposal would require the agreement of state employee unions through collective bargaining. The proposal as-

sumes that new contracts will include these provisions beginning one year after current contracts expire. Since most bargaining units have contracts that do not expire until the end of 2004-05 or later, the administration estimates that higher employee contributions would be phased in. As a result, budget estimates show additional contributions starting at $14 million in 2004-05, growing to $44 million by 2007-08, and declining thereafter (as more new employees are hired into the pre-Chapter 555 plans).

Employees Help Pay for Higher Benefits. This proposal could be viewed as having current state employees share in the additional annual cost of the retirement benefits increase adopted in Chapter 555. We think this makes sense, particularly given the overall level of retirement benefits currently provided to state employees. (See nearby box for a comparison of California benefits to selected other states.)

A Comparison With Other States

It is not an easy task to compare the defined benefit plans among states. This is because there are so many variables that affect the level of pension benefits. In Figure 5 below, we try to control for as many of these factors as possible. (The states shown are larger or western states for which information was readily available to compare to California.) The figure illustrates what a retiree—with a given starting age of work and final salary—would receive at varying retirement ages in California and four other states. It shows that California benefits are more generous.

Figure 5

California Retirement Benefits Compared to Selected Other States

	Employee Retiring in 2004 at Age[a]				Employee Contribution
	55	60	62	65	
California	$25,200	$36,098	$40,958	$46,500	5%
Florida	11,914	20,424	24,439	28,410	—
Illinois	—[b]	24,250	26,115	28,913	4
Oregon	15,242	24,831	26,741	29,606	6
Texas	—[b]	34,199	36,829	40,775	6

a Assumes employee started working for the state at age 34 and has earned $60,000 in salary in the last year before retirement.

b Not eligible for retirement at this age.

Idea Worth Pursuing. While we think the idea is worth pursuing, it is unclear at this time what concessions the administration would have to make in order for unions to agree to an additional employee contribution. As a practical matter, the administration's savings estimate from this provision is overstated in that it does not take into account these likely added costs. Thus, when reviewing negotiated contracts for approval, the Legislature will have to consider the merits and costs of the total package to determine if the higher employee contributions are "worth it."

Additional Contributions Would Not Reduce State Employee Rates Until 2006-07. We reviewed the administration's estimates for its proposal. The assumptions regarding the phasing-in of bargaining units and salary and attrition rates seem appropriate. Thus, the amount of higher employee contributions estimated by the administration appears reasonable. Absent a change in actuarial methods by PERS, however, the *timing* of estimated savings is overly optimistic in the short term. Annual state contribution rates to PERS are based on the status of the retirement plans in place as of June 30 two fiscal years prior. As a result, even with higher employee contributions beginning in 2004-05, PERS would not adjust state rates to account for this additional income until 2006-07. Thus, all state savings from the higher employee contributions would accrue two years later than assumed by the administration. For the budget year, this means a cost of $14 million General Fund. Over a 20-year period, this results in only a minor, downward adjustment in the administration's estimate of General Fund savings.

The administration notes that PERS could choose to take these additional employee contributions into account immediately, thereby offsetting state contributions in the budget year. The PERS board has not indicated to date whether it would do so. If PERS did not, the administration reports that it would propose a greater amount for the pension obligation bond to cover the delayed savings.

Pre-Chapter 555 Benefits for New Employees

The administration proposes negotiating pre-Chapter 555 retirement benefits for new employees. The state, however, could adopt this proposal on its own immediately, without waiting several years for full implementation. This would maximize possible savings.

The Governor's budget proposes additional steps to start containing state retirement costs now. Under the proposal, the defined benefit plans in place prior to Chapter 555 would apply to *new* employees. For most employees, this would be the "1.25 percent at 65" retirement formula under the Miscellaneous, Tier 2 plan. (The Tier 2 plan also includes no

employee retirement contribution.) Correctional officers and state firefighters would receive "2.5 percent at 55" while highway patrol officers would get "2 percent at 50." The administration proposal retains the one-year final compensation basis for benefits instead of returning to the pre-Chapter 555 three-year period.

This proposed change would result in annual state employer retirement contributions for new employees that are smaller than they otherwise would have been. As the state hires more and more new employees, these savings would continue to grow. The administration estimates annual savings of just $6.4 million in 2004-05, but growing to more than $450 million annually by the end of a 20-year period.

Negotiation Not Necessary, State Could Adopt Proposal on Its Own. The administration has assumed that this provision would be negotiated in collective bargaining agreements (in a similar manner as the higher employee contribution discussed above). This delay, however, is not necessary. The state made Tier 2 mandatory for new employees beginning in 1991-92 through trailer bill legislation accompanying the budget act. The state could similarly adopt this part of the administration's proposal to begin in the budget year for all new employees. This would increase savings in the short term.

Savings Estimates Overstated. Based on our review of this proposal, the new employee hiring required to meet the administration's estimated savings is too aggressive. The state's ongoing hiring freeze and the assumed phasing-in of new agreements would limit the number of new state employees that would receive pre-Chapter 555 benefits. We estimate these factors would reduce the estimated annual savings by about half in the short term.

ADDITIONAL OPTIONS FOR CONTROLLING FUTURE RETIREMENT COSTS

We recommend that the Legislature seriously consider the proposal to enroll new employees in pre-Chapter 555 retirement plans. We also recommend that the Legislature consider additional alternatives such as Tier 2 and defined contribution plans for all new employees. These alternatives would result in more state savings and provide other state benefits compared to the administration's proposal.

The pressure that rising retirement costs have recently put on the state budget highlights the ongoing liability the state has for its retirement system. Given the continuing prospect of making $2 billion-plus retirement payments, we recommend that the Legislature seriously con-

sider the Governor's proposal to enroll new employees in the retirement plans in place prior to Chapter 555. We recommend, however, that the Legislature consider additional alternatives as well, such as (1) Tier 2 retirement plans for all classifications and (2) defined contribution plans. As shown in Figure 6, these alternatives could achieve more state savings than the administration's proposal while offering other advantages, as we discuss below.

Figure 6

Features of Retirement Plan Options for New Employees

	Governor's Proposal	Tier 2 for All	Defined Contribution
Retirement Benefits	• Pre-Chapter 555 benefits. • Amount of benefits guaranteed.	• Reduced benefits compared to Governor's proposal. • Amount of benefits guaranteed.	• Benefits depend on contributions and investment returns. • Amount of benefits not guaranteed.
Employee Flexibility	• Not portable. • Employee contribution.	• Not portable. • No employee contribution.	• Portable. • Employee contribution optional.
State Flexibility	• State pays rates determined by PERS.	• State pays rates determined by PERS.	• State can establish contribution level.
Future State Costs	• State "on the hook" for future costs.	• State "on the hook" for future costs.	• State not "on the hook" for any future costs.
State Savings Compared to Current Law	• Significant savings in the long term.	• More savings than Governor's proposal.	• Savings depend on state contribution.

Tier 2 Benefits

Higher Take-Home Pay. Tier 2 pays approximately two-thirds the benefits of Tier 1, and at a higher retirement age. Tier 2, however, also includes no employee retirement contribution. Therefore, take-home pay for a Tier 2 employee is higher than that for a Tier 1 employee with the same position and salary. This has the effect of redistributing lifetime income towards the front end—to be used at employees' discretion—and away from the back end—designated for retirement.

Lower State Costs. In addition, state costs for Tier 2 are also less on a per-employee basis. This is because the benefit to be paid upon retirement, and therefore the total estimated cost, is less than for a Tier 1 employee. For 2004-05, PERS estimates a difference of 4.6 percent of salary between state Tier 1 and Tier 2 contributions. This is significant: for a $40,000 position, a department would pay $1,840 less in retirement costs for a Tier 2 employee in 2004-05. On a statewide basis, existing Tier 2 employees (about 18,000) will save the state $34 million in costs in the budget year.

Option for Tier 2 for All New Employees. The administration proposes enrolling new Miscellaneous state employees in Tier 2. The state could also institute Tier 2 retirement benefit programs for all retirement classifications. In this instance, the Legislature would want to adjust Tier 2 benefits proportionally to reflect the different benefits received by various classifications. (For instance, safety-related employees could receive enhanced Tier 2 benefits.) As noted above, with a lower or eliminated employee contribution, employees would receive increased take-home pay.

Potential Savings of 10 Percent Over Governor's Proposal. Based on the existing difference between Tier 1 and Tier 2 for the Miscellaneous plan, we estimate that Tier 2 plans for all retirement classifications could achieve upwards of 10 percent more savings annually in the long term than the Governor's proposal.

Defined Contribution Retirement Program

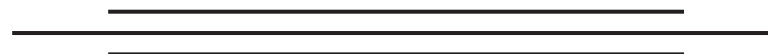
Defined Contribution Plan Limits Future Liability. As discussed above, defined benefit plans create a great deal of fiscal uncertainty for the state as it is on the hook for all rate changes at the margin. To limit their uncertainty, many private sector companies have switched to "defined contribution" retirement programs. In addition, some states such as Ohio, Michigan, Oregon, and Washington have either switched to defined contribution plans or offer such a plan to their employees. Under these plans, companies or governments contribute a certain amount to employees' retirement accounts. Typically, a business contributes a specified percent of salary, matches employee pretax contributions up to a specified percent of salary, or both. As a result, a company or government has no continuing obligation for retirement pensions after contributing the specified amount to employee accounts. With defined contribution plans, there is more uncertainty for the employee in that there is no guaranteed level of benefits upon retirement. These benefits depend instead on stock market performance and overall investment returns.

Portability. In addition, retirement funds under a defined contribution plan are portable for employees who leave the company. Unlike defined benefit retirement plans, both company and employee contributions can be cashed out. Individuals can also "roll over" retirement funds to new employers.

Flexibility in Annual Costs. With a defined contribution plan, the state would be able to set employee and state contributions at any level desired. These decisions could be left to collective bargaining as well. A typical contribution by employers for such retirement plans is 5 percent of salary.

Predictable Expenses. The dollar amount required by whatever rate is set for an employer's defined contribution is the only cost incurred. There is no risk of an unfunded liability to pay off in future years. That is, there are no expenses that cause future retirement rates to go up. Each year has a set identifiable cost, lending greater predictability to state finances.

Potential Savings of One-Third Over Governor's Proposal. Any state savings from a defined contribution plan would depend on the chosen level of the state's contribution. For instance, based on the existing difference between the Tier 1 normal cost and a five percent state contribution, we estimate that defined contribution retirement plans for all new employees could achieve upwards of one-third more savings annually than the Governor's proposal in the longer term.



State Information Technology Projects

In March 2003, the Department of Finance began a statewide assessment of 117 state information technology (IT) projects. The results of the assessment indicate that departments are having problems (1) developing their IT projects and (2) adhering to state policies. Our analysis examines the assessment results, identifies some possible deficiencies in the state's IT processes, and makes recommendations on how the Legislature can address the deficiencies.

Every year, the budget includes funding for many different automation projects. For example, this year the Governor's budget requests funding to install computer equipment in a new state building. Another proposal requests funding for the ongoing development of the federally required child support enforcement system. Even though the state funds many IT projects every year, the Legislature has never had statewide information available on how well the state is actually managing its IT projects. For example, information is not reported on how many IT projects are: (1) under development, (2) meeting estimated budgets and schedules, (3) properly managed, and (4) achieving ongoing benefits. The lack of reported information has limited the Legislature's oversight of the state's IT projects.

Department of Finance Conducts First Independent Assessment of All Projects

Prior to March 2003, the Department of Finance's (DOF) Technology Oversight and Security Unit had conducted a number of reviews and assessments of individual IT projects. Most of these reviews were conducted on a project-by-project basis. Individual project reviews provide information on a specific project. These reviews, however, do not provide statewide information on how well the state is actually developing, overseeing, and completing all of its IT projects. In an effort to better understand the state's overall status of project development and over-

sight, DOF began in March 2003 the first statewide assessment of active IT projects. In June 2003, the results were reported to the state's Chief Information Officer. The primary purpose of the statewide assessment was to establish a baseline of all active projects. Once a baseline is established, the state can measure its performance in project development and oversight over time.

Scope of Assessment. The assessment examined 264 projects initially thought to be in development. Of these projects, DOF found that 147 projects had been completed. The remaining 117 projects were then assessed in two areas: (1) project risk and oversight and (2) adherence to the state's policies on reporting project changes.

Project Risk and Oversight. In February 2003, DOF issued a new state oversight policy, which describes the project management and oversight activities that must occur on state IT projects. The policy requires that each project meeting certain thresholds be assigned a "risk rating" based on a number of quantifiable factors—such as project cost, experience of the project manager, and the type of project. The risk ratings fall into three categories—high, medium, and low. Figure 1 provides examples of typical qualities that projects may have for each of these risk categories.

Figure 1

Information Technology Project Risk Ratings Examples of Possible Project Qualities

Qualities	Low Risk	Medium Risk	High Risk
Cost	• Under $5 million in project costs.	• $5 million to $10 million in project costs.	• Over $10 million in project costs.
Activity	• Involves replacing or upgrading existing computer hardware or software.	• Involves installation of networked or midrange computer systems.	• Involves complex hardware system and customized software.
Staff Experience	• Experienced staff.	• Limited experienced staff.	• No experienced staff.

The risk category determines the level of oversight for the project. High-risk projects have the highest level of oversight. For these projects,

departments must report monthly on the status of the project to DOF and their agency (for instance, the Department of Parks and Recreation reports to the Resources Agency). In addition, high-risk projects must have independent contractors monitoring, evaluating, and reporting on the project status. Medium-risk projects require the agency to review and monitor the project, and low-risk projects are overseen by the department. The DOF's policy also requires specific project and risk management activities for each project. The risk rating determines the extent of these activities. High-risk projects have the most activities and low-risk projects the least amount of activities.

Reporting on Changes in Project Budget, Schedule, and Scope. For all projects with a risk rating, state policy requires departments to report on changes of 10 percent or more in the project's budget, schedule, or scope and receive DOF's approval *prior* to making the change. Project changes must be reported in a Special Project Report that describes the change, the reason for the change, and the impact the change has to the overall project.

Reporting on Completed Projects. According to state policy, departments are required to prepare a post implementation evaluation report (PIER) for each completed state IT project. The PIER must measure the benefits and costs of the implemented IT system and document the projected maintenance and operation costs over the life of the system. The PIER is intended to compare what was *expected* to be achieved versus what was *actually* achieved. State policy requires a PIER to be completed within 18 months of project implementation.

LAO's Review of Assessment Information

In our review of DOF's baseline assessment, we found that most current state IT projects are (1) considered medium to low risk and (2) experiencing some type of project change. In addition, our review indicates that many departments have not submitted PIERs for their completed projects. We discuss these findings in more detail below.

Assessment Reports Most State IT Projects Are Low to Medium Risk. As summarized in Figure 2 (see next page), the assessment found that two-thirds of state IT projects are low to medium risk. This means that most state IT projects (1) do not require oversight by DOF and contractors and (2) do not involve highly complex hardware and software systems.

Project Oversight Lacking in Many Cases. The assessment found that half of the projects did not have adequate oversight. Of the 38 high-risk projects, 15 projects did not have adequate oversight at the time of the assessment. Since the assessment was completed, however, ten of these

projects have implemented the required oversight. The five high-risk projects that still do not have the required oversight are:

Figure 2

Department of Finance's Baseline Assessment Active Information Technology Projects[a]

Department	Projects Reviewed	Project Risk Rating			Projects With a 10% Change[b]
		High	Medium	Low	
Alcohol and Drug Programs	2	1	1	—	2
Board of Equalization	4	—	1	3	—
Child Support Services	2	1	1	—	1
Conservation	2	1	—	1	2
Consumer Affairs	2	2	—	—	—
Corrections	5	1	2	2	4
Developmental Services	2	2	—	—	2
Education	3	2	—	1	3
Employment Development	3	1	—	2	3
Fish and Game	2	1	—	1	2
Forestry and Fire Protection	4	2	1	1	3
Franchise Tax Board	2	1	—	1	—
General Services	4	—	—	4	4
Health and Human Services Agency Data Center	5	5	—	—	3
Health Services	9	6	1	2	9
Highway Patrol	3	—	1	2	2
Justice	13	2	—	11	13
Motor Vehicles	9	—	—	9	9
Social Services	2	—	2	—	1
Statewide Health Planning and Development	3	1	1	1	1
Transportation	12	2	6	4	10
Water Resources	3	1	1	1	3
Youth Authority	2	—	2	—	2
Other Departments	19	6	7	6	11
Totals	**117**	**38**	**27**	**52**	**90**

a As of June 2003.

b In schedule, budget, or scope.

- Department of Consumer Affairs' Electronic Transmission Project.
- California Department of Education's California School Information Services Program Data Integration Project.
- Department of Fish and Game's Automated License Data System.
- Department of Justice's California Palm Print System.
- Department of Water Resources' Business 2000—Phase 2B Project.

Most IT Projects Were Experiencing Project Changes. As summarized in Figure 2, most state IT projects (about three-quarters), regardless of risk rating, were experiencing project changes of 10 percent or more in budget, schedule, or scope. The assessment does not provide detailed information on the extent of the changes that are occurring on these projects. In other words, the extent to which changes are slightly or significantly over the threshold are unknown. Given the complexities of state IT projects, it is not surprising that most departments are experiencing some kind of changes on their IT projects. The key question is in what cases do these changes raise significant issues that must be immediately addressed. The assessment indicates that almost all high-risk projects are having difficulties in reporting project changes as required by the administration. Of the high-risk projects over $10 million, only four were reporting project changes on a timely basis (see Figure 3, next page).

Many Departments Are Not Reporting on Completed Projects in a Timely Manner. At the time the assessment was conducted, DOF found that 147 projects were completed but many PIERs had not been submitted to DOF and the Legislature. (The DOF states that 85 of the 147 PIERs have now been submitted.)

Assessment Findings Indicate Deficiencies In the State's IT Processes

The DOF's assessment report establishes a good baseline to measure the state's progress in implementing its IT projects. In addition, it appears that the assessment has encouraged some departments to prepare PIERs for their completed projects and implement oversight for their high-risk projects.

The results, however, also indicate state IT projects are encountering serious problems:

- Most state IT projects are experiencing changes in scope, costs, or schedule.
- Departments have not adhered to state policies requiring the reporting of these problems.

These problems seem to occur regardless of whether the projects are small or large.

Figure 3

Department of Finance's Baseline Assessment High-Risk Projects Over $10 Million

Department/Project Name	Last Approved Project Cost (In Millions)	Changes in		
		Schedule	Budget	Scope
Alcohol and Drug Programs				
Health Insurance Portability and Accountability Act (HIPAA)	$15.6	X	X	
Child Support Services				
Pre-Statewide Interim Systems Management Project	905.9			
Corrections				
Madrid Patient Information Management System	18.0	X		
Developmental Services				
California Developmental Disabilities Information System	19.4	X		
Employment Development				
Expanding Access to Services Through E-Government	45.7	X	X	X
Fish and Game				
Automated License Data System	21.6	X		
Forestry and Fire Protection				
Computer Aided Dispatching	17.8			
Franchise Tax Board				
California Child Support Automation System	1,300.0			
Health and Human Services Agency Data Center				
Expanded Adoptions System	14.7	X	X	
Electronic Benefit Transfer	441.4			
Statewide Automated Welfare System (SAWS)—CIV	588.5	X	X	
SAWS—CalWin	710.7	X	X	
Children's Medical Services Network/Enhancement 47	19.0		X	
Genetic Disease Branch Screening Information System	32.0	X	X	
HIPAA	29.1	X		
Justice				
Automated Criminal History System Migration	32.3	X	X	

Continued

Department/Project Name	Last Approved Project Cost (In Millions)	Changes in		
		Schedule	Budget	Scope
Mental Health				
HIPAA	12.1	X		
Secretary of State				
Business Process Automation	39.6			
State Treasurer's Office				
Debt Management System	11.0	X		
Transportation				
Transportation Permits Management System	12.1	X		X
Project Resources and Schedule Management	13.4	X	X	
Water Resources				
Business 2000—Phase 2B	53.3	X	X	X
Totals	**$4,353.2**	**16**	**10**	**3**

The DOF assessment only establishes the current baseline. It does not provide the answers to important questions, such as:

- Are state IT projects being properly managed and overseen by their departments?
- What can the state do to ensure projects stay on schedule and within budget?
- Why are departments experiencing problems adhering to state policies on IT projects?

With the information available, we are not able to answer these questions on a statewide basis. Below, we do, however, discuss several possible factors contributing to the problems.

Departments May Not Be Properly Managing IT Projects. One of the simplest explanations for the widespread changes in project budgets and schedules is that departments may not be properly managing their IT projects. For an IT project to be successful, the project must (1) have strong commitment and leadership by the department's executive team, (2) use good project management practices, (3) have measurable objectives, (4) have strong contract administration and management, and (5) successfully manage change and risk. Since DOF's assessment did not examine how well departments were managing their projects, it is unclear how much of the project changes can be attributed to poor project

management. The DOF's ongoing oversight system is designed to better identify mismanaged projects in the future. This oversight system needs to be integrated, however, with a permanent IT governance structure (a proposal for such a governance structure is currently pending before the Legislature in SB 403 [Florez]).

Departments May Prepare Poor Estimates for Project Budgets and Schedules. Another reason for the widespread problems in meeting project budgets and schedules could be that departments prepare unrealistic estimates of the time and money it will take to accomplish the project. With the current tight budget situation, departments may be "low balling" project costs. In other cases, departments may be using poor estimating techniques. Both situations would result in departments preparing estimates not based on the true costs of what it will take to address the identified problem. The state does not require the use of a standard estimating technique for project budgets and schedules. Since there is no state standard for project estimating, initial project budgets and schedules could be inconsistent and inaccurate. Problems in the estimates may become apparent only *after* the project is underway.

Review Process May Discourage Compliance. The assessment found that most departments are not following the requirements to report project changes and receive DOF's approval before making the project change. In some circumstances, though, DOF's management of its IT workload may be discouraging departments from complying with state policy. For example, during DOF's busiest budget preparation times, projects that are experiencing changes but *do not* require a budget action are given lower priority in DOF's reviews. As DOF is not required to complete its reviews within a specific timeframe, departments can wait several months before DOF approves the project change. To comply with the state policy in this example, a department must either stop or slow down the project. When DOF eventually approves the change, the project could again have a budget or schedule problem since it waited for DOF to complete its review.

In other cases, the 10 percent threshold for reporting changes to DOF may discourage compliance. For some projects, a 10 percent level may not represent a significant project change. For example, for a $300,000 project, a $30,000 change could result from purchasing the most current hardware or software for the new system. In such a case, the department may be able to redirect existing funds to pay for the additional hardware and software costs. Yet, state policy requires DOF to review and approve the request before the department is able to make the purchase. While ignoring state policy should not be considered acceptable behavior, departments may be ignoring reporting requirements in some cases for practical and reasonable reasons such as keeping their projects from being further delayed.

Actions the Legislature Can Take To Address Causes of Project Deficiencies

To address the findings of the DOF assessment, we recommend the Legislature take two actions described below.

Require Departments to Report on Assessment Findings. First, we recommend that the Legislature require departments with high-risk projects over $10 million (see Figure 3) to report at budget hearings on the assessment's findings regarding their projects. Departments should be able to explain why delays and other deficiencies went unreported, as well as what actions have been taken to correct identified problems.

Direct DOF to Review State's IT Policies. Some of the problems found in the assessment may be indicative of deficiencies in the state's policies and review procedures. To address these problems, we recommend that DOF reexamine its policies on reporting changes. Now that the state's project risk rating system is in place, DOF should update its reporting policies to reflect those variations in risk. Specifically, DOF should (1) increase the threshold for reporting project changes on low- and medium-risk projects and (2) allow some changes to occur without prior DOF approval. We also recommend that DOF examine the need for statewide standards for estimating project budgets and schedules. Statewide standards could improve the ability of departments to accurately reflect realistic budgets and schedules in their initial proposals.

Contracting Out for State Services

Based on provisions in the California Constitution, services provided by state agencies generally must be performed by state civil service employees. Article VII, Section 1, of the Constitution provides for the establishment of the state's civil service system:

> (a) The civil service includes every officer and employee of the State except as otherwise provided in this Constitution.
>
> (b) In the civil service permanent appointment and promotion shall be made under a general system based on merit ascertained by competitive examination.

While this article does not expressly prohibit the state from contracting out, the courts have held that it restricts the use of nonstate employees in many circumstances. Consequently, case law and state statute have established parameters for contracting out state services. State law requires that proposals for contracting must, at a minimum, meet the following criteria:

- Contracts must result in cost savings to the state.
- Contractors' wages may not significantly under-cut state pay rates.
- Contracts cannot cause the displacement of civil service employees.

In November 2000, Proposition 35 added Article XXII to the Constitution to explicitly allow for the contracting out of services for architectural and engineering services. These are the only types of state services with such authorization.

Administration's Proposal

The administration proposes a constitutional amendment to expand the circumstances in which the state can contract with private entities. While the administration has not yet released the specific language of its proposal, the stated purpose of the amendment will be to permit the state

to "contract with non-state entities for ministerial functions whenever doing so will reduce costs, improve efficiency, or improve services." The constitutional amendment, if approved by the voters, is intended to provide greater legal certainty and therefore opportunities to contract out for services. In conjunction with this constitutional amendment, the administration is also proposing in the *2004-05 Governor's Budget* to contract for services currently provided by state employees. For instance, the administration proposes such changes in the Departments of Developmental Services and Veterans Affairs.

Key Considerations

In *The 1996-97 Budget: Perspectives and Issues* (please see pages 173-189), we discuss the advantages and disadvantages of the privatization of state government functions. Contracting for services is one of the more common means of privatizing state government. The evidence suggests that carefully managed privatization can, under the right circumstances, provide specialized expertise, save money, and/or result in improved service delivery. It also shows, however, that poorly managed privatization, or privatization under the wrong circumstances, can lose money and result in poor service delivery.

In the report, we also discuss the challenges that governments face when they privatize. Understanding the potential problem areas and being aware of the risks involved are important for maximizing the likelihood that privatization will be successful. As the Legislature evaluates the administration's proposed constitutional amendment and the specific contracting proposals, it may want to consider the following:

- ***Accountability.*** How can government ensure that it does not "lose control," but rather retains an appropriate degree of oversight and responsibility for provision of a service being privatized?
- ***Accurate Cost Comparisons.*** Government needs to ensure that it accurately projects the savings from privatizing. This requires accurate cost comparisons between providing a given service directly by the government and by the private sector.
- ***Realization of Net Benefits.*** What steps are needed to ensure that the potential benefits of privatization are captured for taxpayers? For example, how can government make sure that potential benefits to taxpayers are not shifted to contractors through increased profit margins and overcharging, as has reportedly happened to some governments elsewhere throughout the country?
- ***Quality Control.*** What steps can be taken to make sure that the desired quality of privatized services is provided and maintained?

- ***Service Disruptions.*** How can governments protect against untimely disruptions in the provision of needed public services by private entities with whom they contract, either due to lack of adequate performance or withdrawal from service?
- ***Transitional Workforce Problems.*** How can governments best deal with the practical transition problem of one-time government job losses that will occur when, for example, private sector jobs replace government jobs? Some governments have dealt with this situation by requiring contractors to give laid-off public workers priority when hiring.
- ***Dismantling of Public Institutions and Skills.*** If privatization shifts the provision of governmental services from existing public institutions and governmental workforce to private parties, what are the short-term and long-term implications of dismantling these institutions and losing these public labor skills, in the event that privatization turns out to be less desirable than initially hoped for?

Evaluating Future Economic Development Program Proposals

Technology, Trade, and Commerce Agency Eliminated in Current-Year Budget

The *2003-04 Budget Act* abolished the Technology, Trade, and Commerce Agency (TTCA) and state funding for many of its programs designed to encourage economic development. The state's adverse fiscal condition precipitated the elimination of the agency. Even during better fiscal times, however, we had long questioned the value and impact of many agency programs. Indeed, even at its peak level of funding, TTCA's programs assisted a very small portion of targeted industries or businesses. In other words, almost all economic activity in California occurred without the agency's direct intervention through various programs providing services or subsidies to businesses.

The Governor's budget does not propose any restored funding for these programs. In the future, however, the Governor's budget or other legislation may propose restoring some of these programs or creating new ones to promote economic development. In this piece, we highlight some issues for the Legislature to consider when reviewing any future economic development proposals.

State Involvement Should Be Unnecessary in Most Cases

The state plays a critical economic development role in establishing the social and physical infrastructure for business activity and economic growth. Two of the most prominent and important examples are (1) the K-12 and higher education systems to provide an educated workforce and (2) the transportation system to promote the efficient movement and provision of goods and services.

State involvement should be unnecessary in most individual business transactions. Exceptions can arise in the case of "market failures," in which transactions among businesses produce less than efficient, or optimal, out-

comes. For instance, a number of federal and state programs target small businesses because it is believed that they are often not able to compete or procure services on a level footing with larger companies having more resources at their disposal. Other situations may arise where state involvement may be justified due to concerns regarding the distributional results of market conditions which are not viewed as appropriate. For example, certain economic development programs may be specifically directed towards areas with high rates of unemployment and poverty.

Academic Studies Often Show Little Impact From Programs

Extensive academic studies have evaluated the effectiveness of local, state, and federal government economic development programs. These studies separate out the effects of many variables on economic development or business activity. On occasion, a comprehensive study will conclude that a program has a measurable, positive impact on business activity or economic development. They often find, however, that (1) particular government programs have a small impact, if any, on the measures studied—employment or sales growth, for example—or (2) they have a poor cost/benefit ratio.

Past LAO Reviews of Agency Programs Skeptical of Reported Benefits

Often lacking the data, time, and expertise to perform such complex studies, the state must typically rely on less comprehensive evaluations. However, these analyses can still lend significant insights into program outcomes, lead to reasonable conclusions about program effectiveness, and serve as the basis for good policy decisions.

Determining* Net *Impact Is Critical. In the past, our reviews of TTCA programs found that the data offered by the agency often did not accurately address program effectiveness. The fundamental question of how recipient businesses would have performed in the program's absence was often unanswered. For example, if new sales or jobs would have occurred without the program, then those results cannot truly be claimed as an outcome or benefit of the program. Data that accurately demonstrate program impact would account for this underlying growth and only focus on *additional* business activity among assisted businesses.

As an example, the cost-benefit analyses the agency completed for the state's foreign trade offices counted the entire value of transactions in which the state was involved as a program benefit attributable to the offices' presence. This conclusion assumes that absent the state's intervention, these exports and foreign investments would not have occurred otherwise. That is, the agency claimed responsibility for the full value of

all these exports—an assumption that overstated the value of the offices' involvement with these transactions and, more generally, direct state intervention in foreign trade.

As an alternative, to determine a better estimate of the effectiveness of the foreign trade offices, the agency could have asked assisted businesses about the impact directly attributable to program assistance. (This is done in an annual survey for the Manufacturing Technology Program, which provides business consulting services to small manufacturers.) In addition, TTCA could have considered overall trade-related activity among similar businesses and/or with the respective foreign countries. This would have presented a more accurate picture—one that highlighted any observed differences between underlying business activity and that of the businesses assisted by the trade offices.

How Should the Legislature Evaluate Future Program Proposals?

We recommend that the Legislature require a well-researched problem, a demonstrable net benefit, and built-in evaluations when considering any future proposals for state economic development programs. This would allow the Legislature to be more certain of the effectiveness of proposed programs.

As discussed above, the most comprehensive academic studies of economic development programs typically show a lack of quantifiable results. As a result, we recommend that the Legislature set a "high bar" when considering any future proposals for state economic development programs. If a proposed program appears to "pan out" with such an approach, then the Legislature could be more certain that the program would have a net impact on business activity. Specifically, as shown in Figure 1, we recommend that the Legislature require the following components in proposals for economic development or trade-related programs.

Figure 1

LAO Recommendations for Economic Development Program Proposals

- ✓ An identified, researched problem in the private market, and an assessment of how state action would address the problem.
- ✓ Benefit-cost ratio greater than one-to-one, without multipliers.
- ✓ Built-in data collection and program evaluation focused on *net* impact.

An Identified, Researched Problem. Proposals—whether programs that are new or reconstituted from the former TTCA—should include a thorough explanation of an identified market failure leading to the proposed state intervention in the marketplace. In addition, it needs to be shown how state intervention would actually help address or mitigate the identified market failure. The proposal should include data and research supporting the conclusions. Such analysis could come from the state's Economic Strategy Panel (responsibility for which has been transferred to the Labor and Workforce Development Agency as a result of the TTCA elimination), relevant data from previous TTCA programs, or data on similar programs sponsored by other states or the federal government.

More Than a One-to-One Return. Programs focused on increasing business activity should, in theory, affect state tax revenues. In fact, TTCA program evaluations often presented data claiming additional state tax revenue in excess of program costs to demonstrate program effectiveness. Given the prevalence of extensive academic studies showing minimal or inconclusive impact from such programs, however, a ratio of new revenues generated by the program compared to program costs that is appreciably greater than one-to-one would provide a "cushion" for the Legislature to be more certain that the proposal would have a net financial benefit. (While there are certainly benefits other than tax revenues from economic development programs, most programs have tended to rationalize their worth using net revenue impacts.)

To enhance confidence in this cushion, no job or other multipliers should be used in evaluating program effectiveness. A recent report from the federal government indicates that job multipliers developed from macroeconomic models of the economy (at a scale of trillions of dollars) are not sensitive enough at the microeconomic level to meaningfully apply to programs aimed at individual businesses (at a scale of millions of dollars or less). In short, the multipliers are not accurate on a small scale. If such a standard of not using multipliers were adopted, the Legislature could be more confident that a program estimated to have a direct, positive impact on targeted business activity and/or state tax revenue would truly be able to achieve this result.

Built-In Evaluations. Proposals should document that the programs will account for baseline business activity in some manner. As a result, any approved programs would automatically be generating data and analyses for future use in reviewing program effectiveness.

DEPARTMENTAL ISSUES

General Government

SECRETARY FOR BUSINESS, TRANSPORTATION, AND HOUSING (0520)

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

Business and Regulatory Agencies

- Alcoholic Beverage Control
- Financial Institutions
- Corporations
- Real Estate
- Office of Real Estate Appraisers
- Managed Health Care
- Office of Patient Advocate
- Stephen P. Teale Data Center

Transportation Agencies

- Transportation
- California Highway Patrol
- Motor Vehicles
- Office of Traffic Safety

Housing Agencies

- Housing and Community Development
- California Housing Finance Agency

Inherited Programs From Former Agency. The *2003-04 Budget Act* eliminated the Technology, Trade, and Commerce Agency effective January 1, 2004. Some of the agency's programs, however, were maintained and transferred to other state entities. The Business, Transportation, and Housing Agency inherited the following programs:

- ***Infrastructure Bank***—Provides loans to local governments for infrastructure projects. Loan repayments become available to finance future projects.
- ***Tourism Commission***—Promotes travel in California through marketing and advertising campaigns, using funds from industry assessments.
- ***Small Business Loan Guarantee Program***—Eleven nonprofit financial development corporations use a reserve fund to back bank loans to small businesses.
- ***Manufacturing Technology Program (MTP)***—Two nonprofit organizations provide business consulting services to small manufacturers.
- ***Film Commission***—Provides a one-stop shop for issuing film permits.

Budget. The budget requests $18 million and 59 positions for the Secretary's operations in 2004-05. This is $5.8 million, or 49 percent, higher than the current-year level, due mainly to the full-year costs of the inherited programs noted above. The Secretary's support includes $4.8 million from the General Fund, $1.3 million from the Motor Vehicle Account, and $4.9 million in reimbursements from the agency's constituent departments and the Employment Training Panel (for MTP).

General Fund Savings Possible From Film Activities

We recommend that the Film Commission use existing statutory authority to charge fees for its film permitting activities to cover its costs. This would provide General Fund savings of $0.8 million. We further recommend that the Legislature transfer the $1.1 million fund balance from the inactive Film California First program, for an additional one-time General Fund benefit. (Delete Item 0520-001-0001 and increase reimbursements by $832,000. Transfer $1,073,000 to the General Fund.)

Film Commission Has Statutory Authority to Charge Permit Fees. The Film Commission serves as a one-stop shop for issuing permits to crews filming on state property and more generally promotes the state to the film industry. Film projects currently do not pay fees to get permits. Rather, the General Fund pays the costs of permitting. The commission,

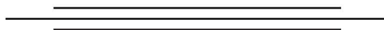
however, has statutory authority to charge fees to cover the costs of filming on state property and state employee services. It is reasonable for film projects to pay for these permits as a basic cost of doing business. Therefore, we recommend that the Legislature require the Film Commission to charge fees to cover its costs. This would result in $832,000 in ongoing General Fund savings.

Transfer Funds From Inactive Film California First Program. Started in 2000-01, the Film California First program subsidized filming-related fees that movie and television production crews paid to the federal and local governments for on-site filming in California. Reimbursements covered costs such as public safety expenses and public property use fees. The program was discontinued in the current year and no funding is proposed for 2004-05. There is, however, $1.1 million in unspent General Fund dollars previously provided to the program.

In last year's *Analysis* (please see pages F-103 to F-104), we concluded the following:

- There was no rationale to favor this particular industry over others by subsidizing reasonable business expenses.
- The program was unlikely to affect filming location decisions since it covered only a small fraction of filming costs.

Given our review of the program, we recommend the Legislature approve the administration's proposal not to fund this program in 2004-05. Moreover, there is no reason for these idle funds to remain in the program's account. Therefore, we also recommend that the Legislature transfer the remaining $1.1 million back to the General Fund.



State Controller's Office
(0840)

The State Controller is responsible for (1) the receipt and disbursement of public funds, (2) reporting on the financial condition of the state and local governments, (3) administering certain tax laws and collecting amounts due the state, and (4) enforcing unclaimed property laws. The Controller is also a member of various boards and commissions, including the Board of Equalization, the Franchise Tax Board, the Commission on State Mandates, the State Lands Commission, the Pooled Money Investment Board, and assorted bond finance committees.

The Governor's budget proposes expenditures of $107 million ($69 million from the General Fund) to support the activities of the State Controller's Office (SCO) in 2004-05. This amount is a decrease of about 4 percent from estimated current-year expenditures.

Fees Appropriate for the Unclaimed Property Program

We recommend that the Legislature adopt a fee to cover the costs of administering the unclaimed property program ($13.8 million annually). In the budget year, accounting for implementation time, this fee could generate $6.9 million in increased revenues.

Unclaimed Property Program. Since 1959, banks and other institutions have been required by law to remit unclaimed property to the state. The most common types of unclaimed property are bank accounts, safe deposit box contents, stocks, and the proceeds of insurance policies. Most property is deemed unclaimed when an account has remained dormant for three years and efforts by the institution holding the account to locate the owner have been unsuccessful. The unclaimed property is then transmitted to the Controller, who maintains records of all such property and attempts to identify the owners. Owners can then file with the SCO to claim their property. Current law requires the SCO to complete its review

of all filed claims within 180 days. The SCO approves claims once the owner's identity is confirmed.

$3.4 Billion in Unclaimed Property Held by State. According to the SCO, the state currently holds in excess of $3.4 billion in unclaimed property belonging to over five million individuals and organizations. This amount tends to grow each year, as new revenues exceed claims paid out. As Figure 1 shows, in 2003-04, the state expects to receive over $750 million in unclaimed property revenues and return $140 million to approximately 170,000 individuals and organizations.

Figure 1

Abandoned Property Revenues

(In Millions)

	Actual 2002-03	Projected 2003-04	Projected 2004-05
Revenues Collected			
Abandoned property	$366.4	$319.9	$319.9
Chapter 304	—	43.3	95.3
Sale of securities	58.8	389.5	72.4
Penalty and interest collected	6.5	7.1	7.1
Totals	**$431.7**	**$759.8**	**$494.7**
Total claims paid	-174.1	-143.1	-200.3
Net Revenues to General Fund	**$257.6**	**$616.7**	**$294.4**

Recent Changes to the Program. Recently, there have been a number of changes in the unclaimed property program, which have the effect of increasing revenues to the fund:

- Chapter 304, Statutes of 2003 (AB 378, Steinberg), increases the types of property which must be remitted to the state. Chapter 304 also shortens the time before cashiers checks are transferred to the state (from five to three years). As shown in Figure 1, the SCO estimates that Chapter 304 will increase revenues by over $138 million for the current and budget years combined.
- In past years, the department held on to securities for up to two years prior to their sale. This year, the department is selling all securities on hand and has begun selling any new securities immediately upon receipt. Consequently, sale of securities is ex-

pected to generate $330 million more this year than in 2002-03. The department projects that the revenues from securities will then drop to $72 million in the budget year.

- Chapter 228, Statutes of 2003 (AB 1756, Oropeza), eliminated the payment of interest for all claims. The SCO estimates this will reduce claims paid by about $15 million annually.

Recommend Fee to Cover All Program Costs. Currently, the General Fund pays the costs for administering the program. The budget proposes $13.8 million for this purpose. We believe the assessment of a processing fee for this program is appropriate, as customers are receiving a service from the state. A fee would allow the offset of General Fund costs without affecting the level of service provided. A simple fee structure could approximate the administrative costs of processing different types of claims. We recommend that the Legislature implement a fee on all approved claims at a level sufficient to cover the program's administrative costs. The implementation of a fee could take as long as six months. Thus, a fee would result in about $6.9 million in revenues in 2004-05 and $13.8 million in future years (with equivalent General Fund benefits).

CALIFORNIA GAMBLING CONTROL COMMISSION (0855)

Established by Chapter 867, Statutes of 1997 (SB 8, Lockyer), the California Gambling Control Commission (CGCC) (1) monitors and enforces the terms of tribal-state gaming compacts (including the administration and distribution of funds received by the state as a result of Indian gaming activities), (2) licenses and regulates card rooms, and (3) provides oversight for specified aspects of horse track betting. The five-member commission is appointed by the Governor.

The Governor's budget proposes $52 million in expenditures ($46 million from the Indian Gaming Revenue Sharing Trust Fund, $4 million from the Indian Gaming Special Distribution Fund, and $2 million from the Gambling Control Fund) and 46 positions for support of the commission and its activities. In anticipation of renegotiated revenue sharing agreements with tribes, the Governor's budget also assumes $500 million in new revenues to the General Fund.

$500 Million Increased Revenue Assumption Risky

The proposed budget assumes $500 million in new revenues to the General Fund in anticipation of renegotiated revenue sharing agreements with tribes. The realization of such revenue in 2004-05, however, is unlikely. When the Governor presents the Legislature with the renegotiated compacts, the Legislature will likely need to weigh the impact of increased gaming against the benefit of any increased revenues.

Tribal-State Gaming Compacts. As a result of the passage of Proposition 1A in March 2000, Class III gambling (such as slot machines and banked or percentage card games) became legal on California Indian land for those tribes that enter into a tribal-state compact approved by the Legislature, the Governor, and the federal government. These com-

pacts lay out the legal relationship between the tribes and the state with respect to Indian gambling. According to the commission, there are currently 109 federally recognized tribes in California, and 64 of these tribes have tribal-state gaming compacts that last until at least 2020. Of those 64 tribes, 51 are currently operating casinos in California.

Three New Compacts. In March 2003, the prior administration entered renegotiations with the gaming tribes in an effort to generate $680 million in new General Fund revenues. No tribes with existing compacts agreed to renegotiated arrangements. The prior administration, however, did come to new agreements with three tribes. The Legislature approved these agreements last year. Unlike the prior compacts, the new compacts require the payments of up to 5 percent of the tribes' winnings to the General Fund.

Existing Revenue Payments. Currently, pursuant to all but the three most recent compacts, tribes pay more than $130 million annually to the state for the right to offer Class III gambling. These revenues are not deposited into the General Fund. Instead, the use of the revenues is restricted to specified uses:

- ***Revenue Sharing Trust Fund.*** This includes $46 million annually in licensing fees to operate gaming machines. These funds are distributed to tribes with no gaming or those operating less than 350 slot machines.
- ***Special Distribution Fund.*** This includes $86 million in fees, based on the average net win of machines in operation as of September 1, 1999. (We discuss this fund in detail below.)

Is the Projected $500 Million in Increased Revenues Likely? The Governor proposes to again enter compact renegotiations with the tribes. The Governor proposes securing $500 million in annual General Fund revenues (beginning in 2004-05) as the result of these renegotiations. It is unknown what amount of revenue, if any, will result from the renegotiations. Yet, in our assessment, it is unlikely that the Governor will secure $500 million in budget-year revenues because:

- Under federal law, the Governor cannot impose a tax on the tribes. The tribes, therefore, must agree to pay any additional monies.
- The $500 million proposed is almost four times what tribes currently pay.
- The budget proposes that the collected revenues go directly to the General Fund, as opposed to the current policy, in which the revenues are used largely in a manner related to the tribes or gambling.

- Since the renegotiated compacts also need to be approved by the federal government, it may be difficult to implement any changes to revenue payments to ensure full-year revenues in the budget year.

The compacts are voluntary agreements, and some tribes could choose to continue to operate under the existing agreements for nearly two more decades. As such, the administration will likely have to negotiate away items of significant value to secure any sizable increases in revenue. For instance, some existing compact tribes have already expressed interest in an expansion of their gaming.

Legislature to Ratify the Renegotiated Compacts. Given these factors, it is risky to depend on tribal gaming as a way of raising large amounts of revenue to help balance the 2004-05 budget. We expect the Governor, following completion of renegotiations, to submit the compacts to the Legislature to be ratified. Regardless of the revenue amount negotiated, the Legislature will likely need to consider whether a greater presence of gambling in the state is worth the increase in General Fund revenue.

Special Distribution Fund—Opportunity for General Fund Savings

The $137 million in available monies in the Special Distribution Fund presents the Legislature the opportunity to help address the budget shortfall. We recommend that the Legislature use the available funds for existing programs, currently funded with General Fund dollars, which address the impact of gambling on communities.

How the Special Distribution Fund Works. Revenues to the Special Distribution Fund are dependent on the number of slot machines in operation as of September 1, 1999. Tribes contribute revenues each quarter to the fund, up to 13 percent of the average net win from these machines. Tribes are expected to contribute $86 million to the Special Distribution Fund in the budget year.

What Can the Funds Be Used For? The fund is subject to legislative appropriation for the following statewide purposes:

- Reimbursement for state regulatory costs associated with implementation of the compacts.
- Grants for gambling addiction programs.
- Grants to state and local agencies affected by tribal government gaming.
- Payment of shortfalls that may occur in the Revenue Sharing Trust Fund.
- Any other purpose specified by the Legislature.

The language of the last item appears significantly broad to allow the funds to be used for any purpose. Yet, a federal district court has ruled that, since this broad statement follows four specific statements related to gambling, all of the funds must be used for gambling-related activities.

What Was Spent in 2003-04? The Legislature appropriated $94 million from the Special Distribution Fund in 2003-04 as follows:

- About $15 million was spent on gambling regulatory activities.
- Chapter 210, Statutes of 2003 (AB 673, Horton), transferred $51 million on a one-time basis from the Special Distribution Fund to the Revenue Sharing Trust Fund to ensure that eligible Indian tribes received the maximum payments allowed ($1.1 million).
- Chapter 210 also established the Office of Problem and Pathological Gambling in the Department of Alcohol and Drug Programs (DADP) to develop a problem gambling prevention program. The DADP was provided $3 million for the program. The administration proposes trailer bill language to repeal Chapter 210 and eliminate a scheduled $3 million appropriation for the same purpose in the budget year.
- Chapter 858, Statutes of 2003 (SB 621, Battin), appropriated $25 million from the Special Distribution Fund to local government agencies affected by tribal gaming.

Commission to Report to Legislature. The above measures also create new reporting requirements. Chapter 210 requires the CGCC to report to the Legislature the amount of funding from the Special Distribution Fund necessary to make up the difference between the $1.1 million maximum and the actual amount paid to each eligible tribe from the Revenue Share Trust Fund. Chapter 858 requires the Department of Finance, in consultation with the CGCC, to calculate the total revenue in the Special Distribution Fund that will be available for local government agencies impacted by tribal gaming. The information is to be included in the May Revision.

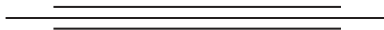
No Spending Plan From Governor. Based on current information, total resources in the Special Distribution Fund in 2004-05 will be roughly $150 million ($86 million in payments from tribes and revenues from past years). The budget proposes expenditures of $13 million for Indian gaming regulatory activities. The administration, however, does not propose expenditures for the remaining $137 million in the fund.

Funds Could Be Used to Alleviate General Fund Pressures. In reviewing the options for spending the fund balance, there are many possible

uses. The impacts of gambling are widespread, even in communities without casinos. Costs related to public safety, road maintenance, and gambling addiction, for instance, affect many cities, counties, and the state. The costs of addressing even one of these areas would easily exceed the Special Distribution Fund's funding.

Given the budget situation and broad parameters of the fund, we recommend using the $137 million for spending which both meets the requirements of the fund and helps the budget situation. For instance, funds currently spent by the General Fund on gambling-related expenses could be replaced with Special Distribution Fund revenues—generating General Fund savings. Below, we outline two such possible uses for the fund revenues as illustrative examples:

- ***Public Safety Demands.*** Gambling activities increase the needs for law enforcement services throughout the state. We therefore believe the Special Distribution Fund could appropriately be used to address these public safety demands. In total, cities and counties spend billions of dollars annually on public safety. The state contributes a small amount of this total annually ($100 million from the General Fund) though the Citizens' Option for Public Safety (COPS) program. If the Legislature continues to fund the COPS program, a portion of the funding could be directed from the Special Distribution Fund. Given the large amounts of money being spent, it is reasonable to assume that such a small COPS-related portion of total public safety expenditures is already spent on gambling-related activities.
- ***Treat Gambling Addiction.*** There are currently many individuals with gambling problems. It is reasonable to assume that some individuals that suffer from this problem seek mental health services. Currently, several hundreds of millions in General Fund dollars are allocated to counties to provide mental health services at the local level. As with the public safety example above, a portion of these General Fund expenditures could be replaced with Special Distribution revenues.



Board of Equalization
(0860)

The Board of Equalization (BOE) is one of California's two major tax collections and administration agencies. In terms of its responsibilities, BOE (1) collects state and local sales and use taxes (SUT), and a variety of business and excise taxes and fees, including those levied on gasoline, diesel fuel, cigarettes, and hazardous waste; (2) is responsible for allocating certain tax proceeds to the appropriate 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 that the Franchise Tax Board (FBB) administers. The BOE is governed by a constitutionally established board—consisting of four members elected by district and the State Controller.

The *2004-05 Governor's Budget* proposes $327 million in support of BOE operations, of which $194 million is from the General Fund with most of the remainder consisting of reimbursements from local governments. The proposed level of total support represents an overall decline in funding of about $1.4 million from 2003-04 levels, and basically level support from the General Fund. The number of personnel years for the BOE is budgeted to remain approximately level for 2004-05 at 3,823.

Minimize Revenue Losses From Budget Cuts

We recommend that the Legislature direct the Board of Equalization (BOE) to reallocate staffing resources so as to mitigate the revenue impact of recent budget reductions. Currently, these reductions are estimated to result in a General Fund revenue loss of $27 million in 2004-05. Altering BOE's current reduction plan would result in recapturing as much as $20 million of this amount. (Redirect staffing and recognize additional $20 million in revenue.)

The BOE's Budget Reduction Plan. As part of the budget reductions specified in Section 4.10 of the *2003-04 Budget Act*, the BOE was required to absorb ongoing annual budget reductions of approximately $16 million and 141 positions. The BOE has chosen to make these reductions in a manner that minimizes the impact on taxpayer services (as opposed to revenue activities), and avoids any staff layoffs. Many of the positions that are proposed to be eliminated or not filled have direct adverse revenue impacts, primarily due to their relationship to audit and collection activities. In addition, while some other positions scheduled to be eliminated are not directly related to revenue losses, they are a component of overall tax processing—the "tax pipeline"—and thus could have an indirect impact on revenues. The agency is unable to assign a particular revenue impact to these latter staffing reductions.

Of the 141 positions being lost, 91 of these positions have a direct revenue impact. The reduction in revenues included in the Governor's budget related to this loss of positions is estimated in 2004-05 to be $35.5 million for all funds and $27 million for the General Fund. Additional local government losses stemming from SUT declines would also occur as a result of these staff reductions.

Budget Reduction Alternatives Exist. Given the magnitude of the revenue losses associated with these staffing reductions, we believe the board should redirect staff resources from nonrevenue-related activities to revenue producing positions—particularly in the audit and collections areas. For example, a temporary shift of some 20 positions from certain taxpayer services activities to audit and collections would result in additional revenues of approximately $6 million in 2004-05, mitigating the negative revenue impacts from the proposed budget reduction plan.

Additional alternatives are also possible. For example, the BOE has in the past shifted some staff resources from revenue activities to nonrevenue activities such as technology services and call centers. (Provision 1 of the BOE's budget authority allows such shifts, provided that the board notify the Legislature of its intent.) A portion of these positions could be moved back to the revenue areas in order to reduce expected revenue losses. By such actions, we think that as much as $20 million in additional revenue could be realized.

While there would be an increase in revenue from such shifts, there would likely be some negative impact on taxpayer services. For example, there might be delays in responding to inquiries or even mailing refund checks.

LAO Recommendation. We recommend that the Legislature direct the BOE to reallocate staffing resources from various nonrevenue-related activities—such as those identified above—to revenue producing posi-

tions, in order to minimize the impact of Section 4.10 budget reductions. The BOE should report at hearings on alternative plans regarding the implementation of the budget reductions.

Board Staff Cutbacks Reasonable

We recommend that the Legislature reduce budget authority for positions for Board of Equalization members to equal actual 2002-03 expenditure levels. (Reduce Item 0860-001-0001 by $0.7 million and special fund reimbursements by $0.3 million and 14 positions.)

In order to accomplish their constitutional and statutory tasks, board members of the BOE are given budget authority to hire professional staff. Such positions include attorneys, auditors, accountants, and other tax professionals. Staff members play an important role in providing board member assistance in their administrative deliberations and tax policy decision-making.

For 2002-03, professional board staff to the four district-elected board members totaled 38 positions, with annual expenditures of $2.9 million. For 2003-04 and 2004-05, 52 positions and a total of $3.9 million is budgeted. This represents an increase in expenditures of 36 percent. Approximately 66 percent of board member professional staff support is from the General Fund, with the remainder coming from reimbursements.

Tasks assigned to board member staff have not changed appreciably since 2002-03. Given the Legislature's concern about the number and compensation of state employees, we believe it is reasonable for board members to absorb reductions in staff resources as well. We consequently recommend that BOE board members' budget authority for personal staff be limited to actual budget expenditures made in 2002-03, and that the Legislature reduce this budget item in 2004-05 by $1 million ($0.7 million General Fund, $0.3 million special funds) and 14 positions.

Local Taxing Entities Should Pull Their Own Weight

We recommend that the Legislature remove the cap on reimbursements from special taxing districts and allow for full reimbursement of associated administrative costs. (Reduce Item 0860-001-0001 by $1.3 million and increase reimbursements by an identical amount.)

As part of its responsibilities, the BOE administers the SUT on behalf of local governments and special districts. Local governments and special districts are required to reimburse the BOE for costs associated with its administrative activities related to the collection and allocation of SUT revenues.

Under legislation adopted in 1998—Chapter 890, Statutes of 1998 (AB 836, Sweeney)—BOE is required in certain circumstances to reduce the reimbursements it receives from special taxing districts for administering the tax. This legislation establishes a maximum reimbursement amount for smaller districts as a means of making special taxes more financially feasible. The statute essentially requires that the state subsidize certain special taxing districts for their administrative costs.

While the establishment of special taxing districts makes the provision of locally based services more feasible, we believe that a strong policy argument can be made that these special taxing districts should be self-supporting, and that administrative costs of taxes that are approved by the voters or public bodies should be borne by them. We therefore recommend that the Legislature end the caps on reimbursements for these administrative costs, reducing General Fund expenditures by $1.3 annually and increasing reimbursements by the same amount.

Field Office Consolidations

We recommend the Legislature adopt supplemental report language directing the Board of Equalization to report by December 1, 2004 regarding field office consolidations and reduction alternatives.

Field Office Activities. In order to administer its various tax programs, the BOE maintains 27 field offices throughout the state along with four out-of-state field offices (Sacramento-based "Out-of-State," Chicago, New York, and Houston). These 31 offices provide access to taxpayers for various information requests and technical assistance. In addition, the field offices are used for housing certain tax auditing and collection activities that may be required in that area of the state (or country).

Do We Need So Many Field Offices? As we note elsewhere, the FTB *also* maintains 16 field offices throughout the state, some of which are co-located with BOE offices. Currently, the FTB is engaged in an ongoing effort to reduce its district offices and develop additional capacity for taxpayer assistance through more effective and efficient means—such as the use of the Internet or various forms of telecommunication. It is also considering additional steps to reduce field office expenses.

Opportunity to Consolidate. While FTB has engaged in an ongoing effort to reduce its reliance on field offices, a similar effort is not occurring at BOE. We recommend that BOE investigate options for field office cost reductions similar to those being explored by FTB. For example, we estimate that the consolidation of certain closely located offices in the southern California area would result in annual savings in the range of $500,000 to $750,000 (largely through lease, furniture, and utility sav-

ings) without resulting in any revenue reductions. This could be coupled with additional taxpayer service and administrative activities provided through Internet or telephone access in order to minimize the impact on taxpayer services.

Similarly, reductions in out-of-state offices could also occur. For example, the Houston office activities could be handled out of the Sacramento-based "Out of State" section. Due largely to one-time staff relocation expenses, the closure of this office would be unlikely to result in any meaningful budget-year savings; however, savings would likely occur in the longer term due to reductions in overall operating expenses.

LAO Recommendations. The opportunity for tax agencies to provide taxpayer assistance and conduct necessary administrative functions through electronic means has improved dramatically over the last decade, reducing the need for a physical presence. We recommend that the Legislature direct BOE to explore alternatives for reducing its reliance on field offices through closures and consolidations, as well as identify and describe additional improvements in the telecommunications area that would provide certain services more efficiently. Adopting the following supplemental report language would be consistent with this recommendation:

> The Board of Equalization (BOE) shall provide to the Chair of the Joint Legislative Budget Committee and the chairs of the fiscal committees of the Legislature by December 1, 2004, a report containing the following information: (1) unit costs of providing taxpayer services and audit and collection activities at the BOE's 27 field offices; (2) net annual budgetary benefits of consolidating or closing four BOE field offices (one in each BOE district); (3) estimated impact on all BOE-collected tax revenues from field office consolidations or closures identified in (2) above; (4) net annual benefits of reducing or eliminating an out-of-state office. Data provided shall include one-time and ongoing budgetary and revenue impacts.

SECRETARY OF STATE
(0890)

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

The budget proposes total expenditures of $69.6 million for the SOS in 2004-05. The two primary sources of funding are the General Fund ($26.7 million) and the Business Fees Fund ($29.4 million).

Budget Fails to Account for Federal Election Funds

The budget fails to account for more than $250 million in expected federal election reform funds. We recommend that the Secretary of State provide the Legislature with a proposed spending plan during the spring.

Federal Election Reform. In October 2002, Congress passed and the President signed the Help America Vote Act of 2002 (HAVA). Under HAVA, California is required to replace specified punch-card machines, create a statewide computerized voter registration system, and make other specified changes to the state's election process. Federal delays in creating its new elections agency to oversee HAVA have slowed guidance to states, as well as expected funding. As the state's chief elections officer, the SOS is charged with administering the state's compliance with HAVA's requirements.

Funding Status. The 2002-03 federal budget included $1.5 billion to assist states in implementing HAVA's requirements. Of the first $650 million distributed in the summer of 2003, the state received $84.5 million in federal funds. Pursuant to Section 28.00 of the *2003-04 Budget Act*, the SOS received authorization to spend $81.2 million in 2003-04 (with $3.2 million reserved for future years):

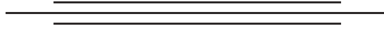
- $1.7 million for SOS administrative costs.
- $57.3 million for counties to replace inadequate voting machines.
- $15.9 million for the education of voters, poll workers, and election officials.
- $3.6 million for voting machines to improve disability and language access.
- $2.7 million to begin the planning process for the voter registration computer system.

In addition, more than $800 million of 2002-03 federal funds has yet to be allocated to states. The recently passed 2003-04 federal budget includes an additional $1.5 billion for election reform purposes. Of these amounts, preliminary estimates indicate California would receive a total of about $95 million in 2002-03 funds and up to $170 million in 2003-04 funds. The SOS notes that the additional federal funds likely will be insufficient to meet all of the federal requirements.

No Spending Plan Proposed. In accordance with federal requirements, the SOS has prepared a 2003 state plan for gaining compliance with HAVA requirements. (The federal government is reviewing the plan and has yet to approve it.) Pursuant to this plan, the department has begun to disburse the $57 million to counties for voting machine replacement. The department also has begun spending its administrative dollars. The department, however, has not begun spending the remaining $22 million in funding already received. Other than the proposed continuation of $1.7 million in administrative expenses, the budget does not propose or acknowledge the expected receipt of the more than $250 million in additional HAVA funds in the current and budget years combined. As such, there is no proposal for how the SOS plans to spend those dollars.

Broad Authority for the Legislature. Federal law limited the use of the $57 million for election machine replacement for this specific purpose. The remaining HAVA funds, however, will be given to California with broad discretion for their use. As long as the funds are used to further the purposes of HAVA, the Legislature will have significant control in determining their use. Given that the new funds may be insufficient to meet all HAVA requirements, the Legislature should ensure that the funds are used efficiently and that the greatest election needs receive priority for the funds. For instance, in order to have the federal funds achieve the maximum benefit, the Legislature may wish to consider whether counties should contribute matching funds. (Counties had such a requirement to receive voter machine replacement funds provided by Proposition 41 in March 2002.)

Budget Proposal Needed. Even though the federal allocations have not been finalized, the Governor's budget should have included a best estimate of the expected funding. We recommend that the SOS provide the Legislature with a proposed spending plan during spring hearings using the best available estimates. This will give the Legislature time to consider its options. The administration can then update its proposal throughout the budget process to reflect the latest and best estimates of expected federal funds.



California Science Center
(1100)

The California Science Center (CSC) is an educational, scientific, and technological center administered by a nine-member board of directors appointed by the Governor. It is located in Exposition Park, a 160-acre parcel just south of the central part of Los Angeles, which is owned by the state. The CSC's budget includes the costs of operating Exposition Park, the California African American Museum, and the Science Center museum. The budget proposes expenditures of $20.1 million for 171 positions in 2004-05 for the department, including $14.2 million from the General Fund, $3.2 million from the Exposition Park Improvement Fund, and $2.6 million in reimbursements. The proposed General Fund expenditures are $1.4 million, or 11 percent, above estimated current-year expenditures, due primarily to the proposed opening of a new elementary school and Center for Learning.

Phase Out State Funding for Operational Costs

The budget proposes the continuation of $8.1 million General Fund for the operation of the Science Center museum. We recommend reducing the request as the museum could be funded by private donations, admission fees, and other nonstate revenues. (Reduce Item 1100-001-0001 by $5 million.)

Background. The Science Center, which was formerly known as the California Museum of Science and Industry, includes an IMAX movie theatre and exhibits on space, the environment, and the human body. The budget proposes $8.1 million General Fund for operational costs of the Science Center. Also, the budget proposes $2.7 million General Fund for payment of lease revenue bonds for the facility. The Science Center is the only museum to receive General Fund dollars of this magnitude on an ongoing basis.

Revenues Not Used to Offset State Costs. In addition to state funds, the Science Center receives private donations collected by the California Science Center Foundation. The foundation is a private organization whose primary purpose is to support the Science Center through fund raising for science exhibits and educational programs. The foundation

also raises funds through the collection of fees for the use of the Science Center's resources. Such fund raising efforts include the rental of museum space (for meetings or parties), charging admission for the IMAX theatre, and a contract with Princess Cruises to provide science activities for cruise guests. The department estimates that these revenues will total $21 million in 2004-05.

According to the Science Center, an agreement between the CSC and the foundation specifies that the net revenue generated from exhibits, educational services, and rental of facilities benefits the exhibit and educational programs of the Science Center. As such, the Science Center does not use these revenues to offset the operational costs currently funded by the state. We are not aware of any restrictions on the Science Center working with the foundation to renegotiate its agreement and expand the use of the funds.

Admission Fee Could Offset Costs. Over 1.3 million people (including 300,000 students) visit the Science Center each year. Currently, there is no charge for admission. An admission fee for museums like the Science Center is common. For instance, the Exploratorium in San Francisco charges admission of $12 for adults and $8 for youths. The San Francisco Academy of Sciences charges admission of $8 for adults and $5 for youths. For the Science Center, even a fee of a lesser amount (with students admitted free) would provide several millions of dollars in funds for the operation of the facility.

Recommend Phasing Out of General Fund. Given the General Fund situation, we believe it is appropriate to identify nonstate funding sources for the operational costs of the Science Center. Based on our review, we believe that the charging of an admission fee, using private donations, and/or the use of revenues generated from the use of the state-owned facilities are appropriate funding sources.

The elimination of General Fund support for operation could be phased in over two years. Accordingly, we recommend the deletion of $5 million General Fund from the Science Center in the budget year. This action would maintain $3.1 million General Fund for operational costs and $2.7 million General Fund for the payment of the lease revenue bonds, which allows the Science Center to operate rent-free. To clarify the Legislature's intent, we also recommend the adoption of budget bill language as follows:

> Item 1100-001-0001, Provision 1. It is the intent of the Legislature that the operations of the Science Center be funded entirely with nonstate funds beginning in 2005-06. The state will continue to provide for the payment of the center's lease revenue bonds.

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 California's personal income tax (PIT) and corporation tax (CT) laws. The FTB also administers the Homeowners' and Renters' Assistance Program, the Political Reform Act audit program, and the Household and Dependent Care Expense Credit. In addition, the FTB administers several nontax-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, and the State Controller. An executive officer, appointed by the board, administers the daily operations and functions of the FTB.

The Governor's budget proposes $560 million ($442 million General Fund) and 5,890 positions in support of FTB operations. Compared to the current-year budget, the level of support represents an increase of $28 million (5.3 percent) and a General Fund increase of $9 million (2.1 percent).

The change in funding is due almost entirely to an increase in support for the California Child Support Automation System (CCSAS). This program is funded largely through reimbursements from other departments but also receives General Fund support. The increase in child-support automation activities is partially offset by decreased support for other FTB activities, including reductions for its core tax administration efforts. Elsewhere in the *Analysis* we discuss shifting responsibility for CCSAS and related child support collection activities to the Department of Child Support Services (see "Health and Social Services" chapter).

ABUSIVE TAX SHELTERS

In recent years, there have been significant concerns raised at the state and federal levels regarding the use of abusive tax shelters (ATSs) by

taxpayers. The FTB indicates that ATS activity has resulted in billions of dollars of state revenue losses over the last four years, and has the potential to cause even more revenue losses in the future. Both the FTB and the Internal Revenue Service (IRS) have taken some recent steps to curb the growth of ATS transactions through statutory changes and administrative policies. However, given the seriousness of the problem, additional steps will need to be considered. We discuss issues related to the growth of ATSs and provide various recommendations regarding them in the *Perspectives and Issues*, "Part V."

FEES FOR FRANCHISE TAX BOARD SERVICES

We recommend that the Legislature adopt legislation to allow the Franchise Tax Board to collect fees for certain special tax services currently provided free of charge to taxpayers and tax practitioners. This action would provide General Fund savings of roughly $3.9 million in the budget year. (Reduce Item 1730-001-0001 by $3.9 million and increase reimbursements by an identical amount.)

Background on FTB Fees. In carrying out its administrative responsibilities with respect to the PIT and the CT, FTB provides certain special services to taxpayers and professional tax practitioners. These services are distinct from typical tax administrative and processing activities of the agency and often represent a substantial commitment of resources for the benefit of individual taxpayers. While these services benefit FTB to some degree in allowing it to carry out its administrative tasks, most of the benefits of such services accrue to individual taxpayers and businesses. Special services provided by FTB include, for example, the tax practitioner hotline, the expedited processing of certain tax forms, and the execution of installment agreements for the payment of back taxes.

The IRS has rather extensive charges for many of its own services. Charges levied by the IRS range from rather modest amounts of less than $50 for copies of tax returns and expedited processing, to several thousands of dollars for providing various administrative requests, letter rulings, and opinions.

Currently, the FTB levies a limited number of fees for particular services and products. For example, it charges cost recovery fees for entity-status letters, copies of tax returns, as well as for certain publications (for example, the *Tax Forms Catalog* and the *FTB Tax News*). In many other cases, however, special services are paid for out of the General Fund. We believe this should be changed, based on the unfairness of requiring some taxpayers to subsidize others or private businesses. Since these activities

benefit private entities, it is appropriate that the costs of such services be borne by them.

Potential New FTB Fees. In previous years, we have recommended that the FTB begin charging tax practitioners for their use of the tax practitioner hotline. This service provides a high level of technical tax expertise to professional tax practitioners. The FTB has raised concerns that a fee for this service would result in merely rechanneling tax practitioner inquiries to either the toll-free line used by all taxpayers or to district offices. Given the technical nature of some tax practitioner requests, however, we are not convinced that the rather general information available to them through the toll-free number or the substantial commitment of time involved in physically appearing at a district office represent realistic alternatives for professional tax practitioners.

We continue to think that a fee for professional tax information is justifiable and appropriate. In addition to charging for the tax practitioner hotline, the imposition of cost-recovery fees would constitute appropriate policy for several other services as outlined below.

- ***Installment Agreements.*** These are agreements that allow certain taxpayers to schedule periodic partial payments on a balance due of under $10,000 that can be fully paid within 36 months.
- ***Refund Stop Payment.*** The purpose of this processing activity is to prevent a refund warrant to be cashed by an unauthorized individual.
- ***Transcript Preparation or Tax Computation.*** These activities require the preparation of a document or report showing annual activity on a taxpayer's account, including: filings, tax amounts, penalty amounts, interest amounts, payments, assessments, credits, and refunds.
- ***Lien Release or Subordination.*** This service requires the review and analysis of extensive documentation in order to determine whether the removal or subordination of a state tax lien from a specific piece of property is appropriate, prudent, and justified.
- ***Rush Services.*** These services provide 24-hour "turn-around" for various actions including corporation reviver (brings a corporation out of suspension), escrow demand (used to process lien releases), entity exemption (for tax-exempt corporation status), and estate income tax certificate (certification of taxes paid).

In each of the above cases, the provision of the service represents a level of activity that is used under special circumstances and thus is not a part of the agency's regular course of business. In most of these cases, the

IRS charges fees for similar services. Furthermore, many of the services provided by FTB have a counterpart in the private sector, requiring the payment of a fee to the lender, bank, or other financial institution providing the service.

Figure 1 indicates the volume of services, proposed fee level, and estimated potential revenue relating to various service fees. Our proposal assumes that fees should cover the full cost of services, since these services are directly linked to individual taxpayers. The fees indicated and the revenue impacts shown are based on a FTB cost-recovery model that incorporates an estimate of the number of minutes necessary to produce each of the specified services. The cost per service uses an annual salary at the mid-range point, plus benefits, and overhead. The number of transactions is based on the volume of such requests in the current year, adjusted for a potential decline resulting from the imposition of a fee.

Figure 1

Franchise Tax Board
LAO Recommended Fees

Type of Service	Projected Volume	Proposed Fee	Projected Revenue
Installment agreements	117,600	$15	$1,764,000
Tax practitioner hotline[a]	200,000	—a	750,000
Refund stop payment	52,345	10	523,450
Tax computation and transcript	47,292	10	516,420
Rush services	20,980	10-75[b]	257,500
Lien release and subordination	500	145	72,500
Total Estimated Revenue			**$3,883,870**

a Amount to be based on recovering the annual costs ($750,000) of maintaining the hotline.

b Fees would vary by cost of service. The weighted average of the four fees included is $12.27.

Administrative Considerations. While it is difficult to levy fees on the provision of certain types of services—due to administrative considerations—levying fees on particular other services would be administratively straightforward. For certain service items, the FTB would be required to establish administrative procedures and technical capabilities for the effective levying of the fee. For example, an annual fee for the tax practitioner hotline would require that a database of tax practitioners in the state be established in order to identify subscribers and track usage.

In addition, the FTB may need to develop a method for tracking the receipt of service fees through modifications to its existing accounting system. The costs of such improvements could be built into the fee structure. Finally, FTB would need to develop various policies that address issues such as at what point the fees should be charged.

General Fund Savings. We estimate that implementing our recommendations to shift funding for various special tax services to fee-based support would result in General Fund savings of about $3.9 million annually. We therefore recommend that the Legislature make corresponding reductions in General Fund support for FTB and increases in reimbursements based on the new fee structure.

REVENUE ACCELERATION AND TAX COMPLIANCE EFFORTS

We recommend that the Franchise Tax Board report at budget hearings regarding (1) the budgetary costs and estimated revenues that would result from the continuation of the department's existing revenue acceleration program, and (2) the viability of a program to require tax withholding on payments to independent contractors.

Revenue Acceleration Program Generates Benefits

As a component of the 2002-03 May Revision, FTB's collections staff budget was augmented by $3.7 million on a limited-term basis for the purpose of accelerating the payment of delinquent tax accounts. The revenue acceleration program (RAP) was established through legislation that allowed FTB to waive the payment of penalties and interest for taxpayers owing balances, in exchange for their immediate payment of unpaid taxes.

The agency was responsible for establishing the eligibility criteria for participation in the program and for contacting potential participants. The program was targeted to taxpayers who had not responded to notices, liens, levies, and telephone or personal contacts for at least two years. Without the RAP program, such accounts would largely be considered noncollectable; no accounts that were deemed to be collectable through other channels were included in the program. The year-long RAP—running from October 2002 through October 2003—resulted in additional tax revenues of $32 million.

Based on preliminary estimates we have received from FTB, the department believes that the cost of extending the RAP for an additional year would be in the range of $1.5 million to $2 million, and result in additional revenues of $23 million, for a net return in excess of $20 mil-

lion. The agency indicates that the program could be reestablished in less than a month.

LAO Recommendation. At the time this analysis was written, detailed information was not available to estimate the net fiscal benefit to the state of the RAP. Given the potential for substantial additional revenue from this program, we recommend that the FTB report at hearings regarding final cost and revenue results of the initial RAP program as well as provide estimated costs and revenues to the state resulting from extending the RAP for an additional year.

Independent Contractors—Bridging the "Tax Gap"

The IRS has identified a federal income-tax gap—defined as the difference between "true" tax liabilities and taxes actually remitted on a timely basis—of approximately $310 billion in 2001. The IRS has indicated that about $81 billion of this amount is the result of nonreported income earned by self-employed individuals and independent contractors. This nonreporting can occur because payments to independent contractors do not require the withholding of taxes. Thus, if the independent contractor does not report the income, it can remain untaxed.

The federal National Taxpayer Advocate—a post established by Congress in 1998—released a report in January of this year recommending an active and vigorous presence in enforcing federal tax laws (see also our discussion in the *Perspectives and Issues*, "Part V" entitled "The Problem of Abusive Tax Shelters"). As a component of her report, the advocate recommended that federal legislation be adopted that would establish withholding requirements for certain categories of nonwage workers. The report indicates that such enforcement is necessary since noncompliant taxpayers implicitly impose a higher tax burden on compliant taxpayers. The report recommends a relatively low withholding rate of 3.5 percent to 5 percent for this purpose, in order to address those situations where an independent contractor experiences little or no tax liability.

The FTB formerly estimated the tax gap for California, but no longer makes such estimates. The federally identified tax gap represents about 15 percent of federal receipts. If this relationship of tax gap and tax receipts holds at the state level, California's potential tax gap would be in the low billions of dollars, with a substantial amount due to under-reporting by independent contractors and the self employed.

The FTB currently has a nonfiler enforcement program that incorporates information received from the IRS as well as certain state sources. The integrated nonfiler compliance (INC) system uses such information to identify nonfilers in order to commence tax enforcement measures.

For example, the FTB receives approximately 6 million 1099 MISC forms annually (filed by companies to report payments to nonemployees) that are used by INC to identify nonfilers. However, if no 1099 MISC is issued by the company, the income may go unreported.

LAO Recommendations. Given the level of concern about the tax gap at the federal and state levels, we think it advisable to consider additional filing and enforcement measures, particularly with respect to independent contractors and self-employed individuals. In particular, we recommend that the Legislature consider that businesses hiring independent contractors be required to report payment amounts and withhold taxes for such payments. Furthermore, we recommend that FTB report at budget hearings with respect to the viability of a withholding proposal similar to that suggested by the National Taxpayer Advocate. The FTB should specifically address the estimated administrative costs and potential revenues from requiring such withholding at the state level.

District Office Consolidations and Reductions

We recommend that the Franchise Tax Board report at budget hearings regarding district office restructuring proposals, including the phasing in of such changes, budget savings, and revenue impacts.

The FTB operates 16 field offices throughout the state—Bakersfield, Fresno, Long Beach, Los Angeles, Oakland, Sacramento, San Bernardino, San Diego, San Francisco, San Jose, Santa Ana, Santa Rosa, Stockton, Van Nuys, Ventura, and West Covina—nine of which are located in privately owned buildings and the remainder of which are located in state-owned facilities. The district offices provide limited public access counters which allow taxpayers to address particular tax-related issues and obtain information and assistance regarding other programs administered by FTB. The district offices also house certain auditing and collections activities.

Taxpayer assistance (as well as assistance with various other programs) is currently available through four channels: (1) a centralized call center with automated and staffed responses, (2) written correspondence through the FTB central office, (3) walk-in accessibility through one of the 16 FTB field offices located throughout the state, and (4) Internet access through the department's Web site.

The department's call center provides the greatest number of personal responses to taxpayers, receiving approximately 3 million inquiries per year. Written correspondence is limited to less than 500,000 inquiries annually. The number of direct taxpayer contacts through public access counters typically ranges from 200,000 to 250,000 annually. In ad-

dition, electronic services (Internet and interactive voice response) receive over 25 million taxpayer contacts; however, such modes do not provide customized services to taxpayers but rather provide specified information based on taxpayers' selection of various "menu" options.

Shift Resources to Most Effective Channels. The public access counters remain the most expensive by far of the channels available for general taxpayer assistance. The FTB estimated that a call center response to a taxpayer inquiry cost an average of $6.07 in 2000-01, compared to $5.21 for a written response, and $11.15 for a field office contact. The FTB estimates that roughly 75 percent to 80 percent of inquiries received through the public access counters can be addressed though the Internet or the call center.

The FTB recently took action to close public access counters at all district offices except for Oakland, Los Angeles, Sacramento, San Diego, Santa Ana, and San Francisco. The department estimates that this will achieve personnel and lease savings of somewhat less than $1 million. After closure, approximately 75 percent of taxpayers are within a 50-mile radius of a public access counter (versus about 95 percent formerly).

In addition to public access, however, it is apparent that many auditing and collection activities now conducted through some field offices could be effectively carried out through alternative means—and at a substantially lower cost. Such alternative administrative venues include: telephone communication, shifts to other district offices, or the transfer of activity to the Sacramento main office. For example, while a physical presence may be required at certain stages of an audit, this presence might be just as effectively met by deploying resources directly from FTB's main office in Sacramento as it is by using staff from a district office.

LAO Recommendation. In view of the substantial commitment of resources required to maintain its district offices for public access and other activities, we recommend that the FTB present district office restructuring proposals at budget hearings including the phasing in of such changes, budget savings, and revenue impacts.

Department of General Services
(1760)

The Department of General Services (DGS) is responsible for providing a broad range of support services to state departments and performing management and oversight activities related to these services. It provides these services through three programs: statewide support, building regulation, and real estate services. Virtually all of DGS costs are reimbursed through fees charged to client departments.

The Governor's budget proposes total expenditures of $874 million from various funds (including $3 million from the General Fund for department administration) to support DGS activities in 2004-05.

Statewide Support

DGS Fails to Lower Service Fees

The Department of General Services (DGS) has not decreased service fees as required by the 2003-04 Budget Act. We recommend that the Legislature adopt budget bill language that requires DGS to implement operational efficiencies and reduce fees.

The DGS has authority to establish the fees its charges client departments. To calculate fees, DGS projects the operating expenses for each of its internal organizations. The DGS then uses this information to develop the fees it will charge departments in order to recover those expenses. When DGS experiences unforeseen cost increases, the fees are reevaluated to determine if the increased costs can be absorbed within the existing fee structure. The budget proposes to continue DGS service fees at their 2002-03 levels.

2003-04 Fee Reductions Approved by the Legislature. With significant budget reductions expected in 2003-04 and 2004-05, DGS client departments will have limited budget flexibility and capability to pay for service fees. Consequently, it is important for service entities such as

DGS—whose budget is based on reimbursements from other departments—to be implementing efficiencies to reduce costs to departments. Consistent with this approach, DGS proposed a decrease in DGS expenditure authority of $17 million and 23 positions for the 2003-04 budget. The DGS stated in the request that it would pursue current-year efficiencies that would result in fee reductions to departments. According to DGS, this expenditure authority reduction was intended to result in 3 percent to 5 percent fee reductions to departments. The Legislature approved this proposal.

Fees Were Not Reduced in 2003-04. Even though DGS proposed and agreed to reduce current-year fees, DGS service fees have not been reduced. According to DGS, it was unable to reduce its fees because (1) the administration chose to transfer $13 million in proposed General Fund expenditures to the Service Revolving Fund (SRF) and (2) DGS was unable to absorb its $14 million increase in employee retirement costs. Because these costs are expected to be ongoing, DGS does not expect to decrease its service fees in the budget year.

Increased DGS Costs Were Anticipated. In our review, we found that the $27 million in cost increases should have been anticipated throughout the budget process. Like the fee proposal, the proposal to shift General Fund costs to the SRF was made as part of the *2003-04 Governor's Budget* in January. Likewise, retirement cost estimates changed only marginally from January to the budget's enactment. If DGS was unable to implement the proposed fee reduction and absorb the cost increases, it should have modified its proposal as part of the May Revision.

Fees Should Be Lowered and Fee Setting Policy Revised. Since DGS agreed to lower its fees in 2003-04 and changes to the DGS budget should have been anticipated, we recommend that the Legislature direct DGS to lower its service fees by at least 3 percent. Most departments have been required to reduce expenses by much greater percentages over the past few years. In addition, we recommend that the Legislature adopt the following budget bill language to ensure these reductions are implemented:

> Upon approval by the Department of Finance on or before September 1, 2004, the Department of General Services shall submit to the Chairperson of the Joint Legislative Budget Committee a revised fee schedule that reflects operational efficiencies and reduces fees to client departments.

Contract Savings Is Overstated

The budget proposes an ongoing $100 million ($50 million General Fund) savings resulting from the renegotiation of state contracts and leases. Since the Department of General Services appears to have overstated savings achieved to date, we recommend that the administration provide revised savings amounts for 2003-04 and 2004-05.

Control Section 5.50 of the *2003-04 Budget Act* and associated statutory language provide the administration new authority to renegotiate state contracts and building leases. Specifically, Control Section 5.50 encourages DGS to renegotiate contracts and leases in order to achieve savings. It also allows: (1) the Department of Finance to reduce department budgets to reflect those savings and (2) departments to keep up to 15 percent of the savings. Control Section 5.50 was expected to achieve $100 million ($50 million General Fund) in savings not accounted for elsewhere in the budget. The budget proposes an ongoing $100 million ($50 million General Fund) savings as a result of these renegotiated contracts. The proposed budget, however, does not include Control Section 5.50 language.

Minimal Savings Have Been Achieved to Date. According to DGS, as of January 2004, it has renegotiated several contracts resulting in a total savings of $32 million (all funds). The administration has not been able to break these savings into General Fund and non-General Fund dollars. The DGS states that it has achieved savings of $15 million from renegotiated leases and $17 million from renegotiated contracts.

Some Savings Overstated and Already Included in Department Budgets. Our review indicates that DGS does not take into consideration savings already included in the *2003-04 Budget Act*. The DGS information overstates the additional savings by about $16 million. For example, DGS states that it achieved savings of $12 million in 2003-04 by renegotiating a contract for the support of the Department of Social Services' Child Welfare Services/Case Management System (CWS/CMS). Our review found that the CWS/CMS contract was renegotiated in 2002-03, and the Legislature approved two 2003-04 May Revision requests to reduce department appropriations to reflect this renegotiation. (These amounts differ from what DGS is currently reporting. We are unable to reconcile the differences.) We also found that $4 million of the $15 million in renegotiated leases was achieved in 2002-03. It appears that the lease reductions were reflected in 2003-04 department budgets. Finally, for the amounts that can legitimately be counted towards Control Section 5.50 savings in 2003-04, it is unclear whether departments have already built the savings into their 2004-05 budgets by reducing their baselines. If so, the savings assumed by the budget would be "double-counted"—both in department budgets and as a lump sum contract savings item.

Administration Should Provide Revised Savings Amount. Since it appears that DGS has achieved minimal savings to date and has not taken into consideration amounts already included in the *2003-04 Budget Act*, the estimate of $100 million in ongoing savings appears unrealistic. During budget hearings, we recommend that the administration provide revised savings amounts for 2003-04 and 2004-05.

REAL ESTATE SERVICES

Asset Enhancement Consultant Services

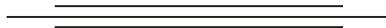
We recommend the Legislature approve $3 million and two positions, on a two-year limited-term basis, to address workload related to disposing of property owned by the Youth and Adult Correctional Agency.

The Governor's budget proposes a $3 million augmentation from the Property Acquisition Law (PAL) Account to fund efforts by the Asset Planning and Enhancement (APE) branch to dispose of properties owned by the Youth and Adult Correctional Agency (YACA). The PAL is a special account in the General Fund that consists of revenue derived from proceeds from the sale or rental of state property. These funds are available to DGS for costs incurred for surplus property while it is under DGS control. In other words, PAL reimburses all DGS costs incurred for the improvement and sale of surplus property. Of the amount requested, $237,000 will be used to fund two permanent full-time positions and $2.8 million will be used for consultant services to conduct environmental reviews, market analysis, advertising, contract negotiations, and escrow closure on the properties.

We understand that the requested augmentation is related to the administration's proposal to evaluate and recommend future facility closures for both the Department of Corrections and the Youth Authority. The Youth Authority already has announced plans to close two facilities by March of this year, and the Governor's budget proposes the closure of the Fred C. Nelles Youth Correctional Facility Camp and an unidentified youth correction camp in 2004-05.

According to APE, its existing staff is fully engaged in efforts to dispose of properties already identified in the 2003 *Surplus Property Report*. Consequently, to the extent the administration has identified new Youth Authority properties for disposal, APE states that it needs two additional Senior Real Estate Officers.

However, because it is not known if any additional YACA facilities will be proposed for closure, there is not sufficient workload to justify these positions on an ongoing basis. Consequently, we recommend approval of the two positions on a two-year limited-term basis.



DEPARTMENT OF FINANCIAL INSTITUTIONS (2150)

The Department of Financial Institutions (DFI) licenses and regulates several different types of entities to protect the funds entrusted by the public to these institutions. These entities include domestic banks, California branches of foreign banks, credit unions, issuers of money orders and travelers checks, and transmitters of money abroad. The DFI is supported by revenues from fees and assessments charged to regulated entities. Most of these fees are deposited in the Financial Institutions Fund and the Credit Union Fund.

The budget proposes $24 million in expenditures and 215 personnel-years (PYs) for 2004-05. This is $2.1 million, or 9.7 percent, more than estimated current-year expenditures and 17 additional PYs. The increase is due to budget proposals to implement a new state law regarding financial privacy (discussed below) and enhance the department's information technology recovery and security capabilities.

State Law on Financial Privacy Faces Federal Preemption Issues

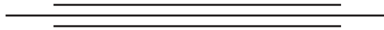
We withhold recommendation on a proposal for $1.9 million and 17 positions to implement Chapter 241, Statutes of 2003 (SB 1, Speier). There are still many unresolved issues regarding the interaction between Chapter 241 and federal law.

The budget proposes $1.9 million and 17 positions for the department to implement and enforce Chapter 241. Chapter 241 establishes particular restrictions on the ability of businesses involved in financial-related transactions to share customer information. Chapter 241 affects the sharing of information with both a business' financial affiliates and independent (nonaffiliated) companies.

Federal Law. Federal law also governs the sharing of information between financial-related businesses. It generally allows states to adopt

stricter measures than its own regarding sharing information with nonaffiliated companies. On the other hand, federal law generally preempts stricter state provisions regarding sharing information with affiliated companies. The federal affiliate provisions were due to expire on January 1, 2004. With these expiring provisions on the horizon, Chapter 241 was adopted in August 2003 and took effect in January 2004. Before Chapter 241 became effective, however, federal legislation permanently extended the preemption regarding affiliates. Chapter 241 includes provisions that are stronger than those in federal law for both affiliates and nonaffiliates. As a result, there are many unresolved issues regarding the interaction between Chapter 241 and federal law.

Proposal Too Broad. The department's proposal is based on full implementation and enforcement of all aspects of Chapter 241. The proposal does not appear to consider the likelihood that some activities will be preempted by federal law. Chapter 241's provisions regarding information sharing among affiliates appear to face the strongest likelihood of preemption. As a result, we withhold recommendation on the proposal pending additional clarification on federal preemption issues.



Department of Corporations
(2180)

The Department of Corporations (DOC) is responsible for protecting the public from unfair business practices and fraudulent or improper sales of financial products and services. The department fulfills its responsibility through its investment and lender-fiduciary programs. The DOC is supported by license fees and regulatory assessments, which are deposited in the State Corporations Fund.

The budget proposes total expenditures of $29 million and 276 personnel-years (PYs) in 2004-05. This is $2.1 million, or 7.8 percent, more than estimated current-year expenditures and 32 additional PYs. The increase is due to budget proposals to implement state laws regarding financial privacy (discussed below) and payday lenders/check cashers.

State Law on Financial Privacy Faces Federal Preemption Issues

We withhold recommendation on a proposal for $1.9 million and 22 positions to implement Chapter 241, Statutes of 2003 (SB 1, Speier). There are still many unresolved issues regarding the interaction between Chapter 241 and federal law.

The budget proposes $1.9 million and 22 positions for the department to implement and enforce Chapter 241. Chapter 241 establishes particular restrictions on the ability of businesses involved in financial-related transactions to share customer information. Chapter 241 affects the sharing of information with both a business' financial affiliates and independent (nonaffiliated) companies.

Federal Law. Federal law also governs the sharing of information between financial-related businesses. It generally allows states to adopt stricter measures than its own regarding sharing information with non-affiliated companies. On the other hand, federal law generally preempts stricter state provisions regarding sharing information with affiliated

companies. The federal affiliate provisions were due to expire on January 1, 2004. With these expiring provisions on the horizon, Chapter 241 was adopted in August 2003 and took effect in January 2004. Before Chapter 241 became effective, however, federal legislation permanently extended the preemption regarding affiliates. Chapter 241 includes provisions that are stronger than those in federal law for both affiliates and nonaffiliates. As a result, there are many unresolved issues regarding the interaction between Chapter 241 and federal law.

Proposal Too Broad. The department's proposal is based on full implementation and enforcement of all aspects of Chapter 241. The proposal does not appear to consider the likelihood that some activities will be preempted by federal law. Chapter 241's provisions regarding information sharing among affiliates appear to face the strongest likelihood of preemption. As a result, we withhold recommendation on the proposal pending additional clarification on federal preemption issues.

HOUSING AND COMMUNITY DEVELOPMENT (2240)

The mission of the Department of Housing and Community Development (HCD) is to help promote and expand housing opportunities for all Californians. As part of this mission, the department is responsible for implementing and enforcing building standards. It also administers a variety of housing finance, economic development, and rehabilitation programs. In addition, the department provides policy advice and statewide guidance on housing issues.

The budget proposes expenditures of $619 million for 2004-05. Spending related to the Proposition 46 housing bond accounts for more than $400 million of this amount. The proposed General Fund expenditures of $14 million—largely for emergency shelter assistance and the operation of migrant farmworker housing—is a 9 percent decrease from the current year. Federal funds account for $147 million of the proposed budget-year expenditures, primarily for the Community Development Block Grant and Home Investment Partnership Act programs. Special funds provide the remainder of the department's expenditures. The department has a proposed staffing level of 481 personnel-years.

MANDATE FOR REGIONAL PLANNING CONTINUES TO SUFFER FROM INEFFECTIVENESS

The regional planning mandate costs much more than the Legislature expected and does not ensure the construction of affordable housing. We recommend that the Legislature eliminate the mandate to save the General Fund about $4 million in annual liabilities.

As part of its general plan, every city and county is required to prepare a "housing element" which assesses the conditions of its housing stock and outlines a five-year plan for housing development. Unlike other components of a local government's general plan, the housing element

must be approved by the state—an activity performed by HCD. Despite the legal requirement of having a housing element approved by HCD, less than 60 percent of local governments currently meet this obligation.

Proposal to Continue Deferral of Costs

Reimbursable Mandate for Some Costs. The basic requirement for cities and counties to develop a housing element (and to have it approved by the state) predates the mandate reimbursement process. The state, however, has since added reimbursable requirements—such as the regional allocation of housing units. Specifically, the state is required to pay regional councils of government (COGs), cities, and counties for these more recent requirements:

- ***Regional COGs.*** Reimbursable costs include expenses related to the administrative costs of distributing the region's total housing goals to individual communities, including public meetings and any necessary revisions.
- ***Cities and Counties.*** Reimbursable costs include expenses related to reviewing the COG's allocation and examining a variety of specialized housing factors in their housing element.

Governor Proposes Deferring Reimbursements Again. As with many other mandates, the *2003-04 Budget Act* appropriated only $1,000 for the regional planning mandate—in effect deferring (with interest) the costs of reimbursements to local governments. For 2004-05, the Governor proposes to again defer these payments. During this deferment, local governments are still required to follow the statutory requirements, and the state continues to accumulate a financial liability for the mandated costs.

Mandate Ineffective. In the *2003-04 Analysis*, we reviewed the regional planning mandate's effectiveness (please see pages F-94 to F-97). We found the following:

- ***Tremendous Variation in Claim Costs.*** The amounts of the claims from local governments vary tremendously—even for claims from similarly sized jurisdictions. Local governments have broad discretion as to what level of effort is appropriate under the mandate.
- ***High Claims Do Not Lead to Compliance.*** Spending time and money on mandated activities does not guarantee an increased number of state-approved housing elements. Some jurisdictions achieved HCD approval while seeking very little in reimbursements. Other jurisdictions submitted sizable claims but never obtained state approval.

- ***Planning Exercise Not Tied to Results.*** The current process has few incentives to encourage local government compliance and accountability. Little follow-up effort is made to ensure that plans are followed and affordable housing is actually built.

While the concept of state guidance and oversight on housing production has merit, the mandate has not achieved its intended results.

Recent Developments Add to Case Against Mandate

Since our analysis last year, there have been three major developments related to the regional planning mandate, as we discuss below.

Mandate Makes No Difference in Housing Production. Last year, the Public Policy Institute of California (PPIC) released a comprehensive review of the state's housing element law. The study compared the housing production during the 1990s of those jurisdictions which had received HCD approval on their housing elements to those which had not. The study found that there was *no significant difference in housing production* between those cities in and out of compliance.

Costs Continue to Rise. Last year, in reviewing submitted claims for the years 1998-99 through 2001-02, we found that local governments had submitted claims totaling $9.9 million. In each of those years, the annual budget bill provided less than $1 million for the reimbursements of local governments. We were concerned that the mandate was costing the state about three times more than the Legislature expected. Since last year, local governments have amended and updated their claims. As a result, for those same four years, total claims now total $13.7 million. In other words, the costs for the mandated activities have risen to about *four times* the amount the Legislature expected.

Working Group Has Not Focused on Costs. In the summer of 2003, the department convened a working group of local government, housing, and business representatives in order to address ongoing problems with the overall housing element process. As a result of the working group's meetings, the department has begun implementing changes in its review process for housing elements to improve consistency. In addition, the department reports that the working group has reached conceptual agreement in several areas and hopes to sponsor legislation this year implementing reforms. The department and the working group, however, have not dedicated much effort to addressing the rising costs of the mandate.

Mandate Not Worth the Cost

Recommend Eliminating Mandate. The recent PPIC study and the mandate's rising costs add further doubt to the mandate's effectiveness. Based on this evidence, we conclude that the current process is not worth the $4 million it will cost to continue in 2004-05. Consequently, we recommend that the Legislature eliminate the existing mandate. As noted above, the mandate only applies to specific components of the housing element process. Even with the repeal of the reimbursable components of the process, the basic requirement to develop a housing element would not change. Instead, the more recent requirements simply would become advisory rather than required.

Better to Start From Scratch. If the Legislature wishes to impose certain mandated requirements, we believe the best approach would be to "start from scratch." The broad discretion of the existing mandate would make it difficult to simultaneously reduce costs and maintain existing requirements. A new process for planning and building affordable housing in the state could be developed through the normal legislative process. Any proposals from the department's working group could be integrated into that process.

OTHER ISSUES

Transfer School Facilities Fund Balance

The state's school facility fees reimbursement program has available bond funds that will meet the program's needs throughout the decade. We recommend that the Legislature transfer to the General Fund the available $5.6 million in nonbond funding. (Transfer $5.6 million from Item 2240-115-0101.)

History of General Fund Spending. The School Facility Fee Affordable Housing Assistance Program reimburses the purchasers of new homes for some or all of the school facility fees paid on their homes. Although the funds are in HCD's budget, the program is administered by the California Housing Finance Agency. From 1998-99 through 2001-02, the Legislature appropriated $27 million for this programs (net of various transfers). Due to low demand for the program, concerns about the program's design, and the state's worsening fiscal condition, Chapter 114, Statutes of 2001 (AB 445, Cardenas), sunset the program at the end of calendar year 2001. (Please see our January 2001 report evaluating the program.) Chapter 114 returned the remaining program dollars to the General Fund but authorized any subsequent payments from home buyers (for instance, if they sold their home before the required five years of

residence) to remain with the program. The department reports a total of $5.6 million has been returned to the program in this manner. (These funds, however, could be transferred to the General Fund.)

Bond Funds Now Available. In 2002, the Proposition 46 housing bond provided $50 million to the program. In its first year of bond funds, the program spent or committed about $6 million. At a similar level of spending, the bond funds should last the program throughout the decade.

Recommend Transferring Available Dollars. Given the programs' available bond funds, the General Fund balance would be better served addressing the state's budget problem. Accordingly, we recommend the Legislature transfer the available $5.6 million, as well as any such funds in the future, to the General Fund.

Shut Down Dormant Child Care Program for Savings

Due to a lack of funding, the Child Care Facilities Financing Program is dormant and not making any new loans. We recommend that the Legislature shut down the program and transfer the $1 million in program reserves to the General Fund. (Transfer $721,000 from Item 2240-115-0472 and $248,000 from Item 2240-115-0474.)

Program Has History of Problems. The Child Care Facilities Financing Program provides both direct loans and loan guarantees for child care facility purchases, expansions, or renovations. General Fund appropriations have provided the program with its previous funding. As we have noted in the past (see, for instance, the *2000-01 Analysis*, page F-130), the program has suffered from a complicated administrative structure and low demand. In recognition of these problems and as a result of the state's worsening budget situation, the Legislature returned to the General Fund much of the program's original funding.

Program Shifted Back to HCD. Although HCD is the program's administrator, the department had relied on the Technology, Trade, and Commerce Agency (TTCA) to carry out the day-to-day management of the program. With the recent shutdown of TTCA, HCD reacquired full management of the program. The program is currently dormant in terms of making new loans and guarantees. Instead, the only function of the program is servicing the existing 19 loans (with a value of $7.7 million) and 2 guarantees (with a value of $730,000) for as long as the next 30 years. The program's accounts are projected to have a fund balance of roughly $1 million at the end of the current year.

Shutdown Recommended. For TTCA's other programs that were ended, the fund balances were transferred back to the General Fund. The revenues from any loan repayments will now come to the General Fund

(as well as the responsibility for administering any outstanding loans). Given its inactivity, we find this approach appropriate for the child care facilities program as well. Consequently, we recommend that the Legislature shut down the program and transfer the remaining funds to the General Fund. This would provide an immediate benefit of $1 million, with future benefits as loans are repaid. Given the program's small portfolio, we do not believe the state should dedicate any significant resources to further administrative costs. Any such costs, therefore, should be able to be absorbed by the department.

STEPHEN P. TEALE DATA CENTER
(2780)

The Stephen P. Teale Data Center (TDC) is one of the state's two general-purpose data centers. The other is the Health and Human Services Agency Data Center (HHSDC). The TDC provides a variety of information technology services to numerous state agencies which reimburse the data center for its operational costs.

The budget proposes $96 million from the TDC Revolving Fund for support of the department in the budget year. This is a decrease of $2.4 million, or 2 percent, below estimated current-year expenditures.

Withhold Recommendation on Data Center Expenditure Authority

The administration has not submitted the required report for the consolidation of the Stephen P. Teale Data Center (TDC) and the Health and Human Services Agency Data Center. We withhold our recommendation on TDC's expenditure authority pending receipt and review of the report and consolidation plan.

Administration Has Not Provided Data Center Consolidation Report. In order to increase the efficiency of the state's technology services, the 2003-04 budget began the process of consolidating TDC and HHSDC. (Please see the *2003-04 Analysis* pages F-47 to F-52 for a discussion of the benefits of this approach.) As required by Chapter 225, Statutes of 2003 (AB 1752, Oropeza), the Department of Finance was required by December 1, 2003 to submit a plan describing the consolidation of the two centers in 2004-05. Specifically, the plan was to include: (1) the organizational structure of the consolidated data center, (2) identification of data center activities that would result in savings of $3.5 million General Fund in 2004-05 and additional savings to be potentially received in future years, and (3) examination of transferring department data servers to the consolidated data center. In October 2003, the new administration notified the Legislature that the required report would become a progress report—

giving it more time to become familiar with the issues of consolidating the two data centers. The progress report has not been submitted to the Legislature.

Withhold Recommendation Pending Receipt and Review of Report. Since the Legislature has not received the progress report, we withhold recommendation on TDC's expenditure authority pending receipt and review of the administration's consolidation proposal.

Health and Human Services Agency Data Center (4130)

The Health and Human Services Agency Data Center (HHSDC) provides information technology (IT) services, including computer and communications network services, to the various departments within the Health and Human Services Agency. The center also provides services to other state entities and various local jurisdictions. The cost of the center's operations is fully reimbursed by its clients. The budget proposes $311 million for support of the data center in 2004-05, which is a decrease of $3 million, or 1 percent, below estimated current-year expenditures.

One of HHSDC's duties is supporting the Department of Social Services' (DSS) Child Welfare Services/Case Management System. In the DSS write-up of this *Analysis*, we discuss the recent federal funding reduction for the support and operation of this system (please see the "Health and Social Services" chapter).

Data Center Consolidation

Withhold Recommendation on Data Center Expenditure Authority

The administration has not submitted the required report for the consolidation of the Stephen P. Teale Data Center and the Health and Human Services Agency Data Center (HHSDC). We withhold our recommendation on HHSDC's expenditure authority pending receipt and review of the report.

Administration Has Not Provided Data Center Consolidation Report. In order to increase the efficiency of the state's technology services, the 2003-04 budget began the process of consolidating Stephen P. Teale

Data Center and HHSDC. (Please see the *2003-04 Analysis* pages F-47 to F-52 for a discussion of the benefits of this approach.) As required by Chapter 225, Statutes of 2003 (AB 1752, Oropeza), the Department of Finance (DOF) was required by December 1, 2003 to submit a plan describing the consolidation of the two centers in 2004-05. Specifically, the plan was to include (1) the organizational structure of the consolidated data center, (2) identification of data center activities that would result in savings of $3.5 million General Fund in 2004-05 and additional savings to be potentially received in future years, and (3) examination of transferring department data servers to the consolidated data center. In October 2003, the new administration notified the Legislature that the required report would become a progress report—giving it more time to become familiar with the issues of consolidating the two data centers. The progress report has not been submitted to the Legislature.

Withhold Recommendation Pending Receipt and Review of Report. Since the Legislature has not received the progress report, we withhold recommendation on HHSDC's expenditure authority pending receipt and review of the administration's consolidation proposal.

OTHER ISSUES

Withhold Recommendation on Transfer of Payroll System

The budget proposes to transfer the In-Home Supportive Services/ Case Management Payrolling System to the Department of Health Services' Fiscal Intermediary contract. We withhold our recommendation on the proposal pending the outcome of the federal government's review.

The budget proposes to (1) maintain HHSDC's expenditure authority of $1.7 million and (2) extend six limited-term positions for the reprocurement of the In-Home Supportive Services/Case Management Payrolling System (IHSS/CMIPS). The IHSS/CMIPS system provides case management and payroll services for the IHSS program.

Project Background. The IHSS program was established in 1973 in DSS as a program to provide in-home supportive services to qualified, aged, blind, and disabled persons. In 1979, DSS contracted with Electronic Data Systems (EDS) for the development and operation of IHSS/CMIPS. In 1998, DSS was directed by state control agencies to conduct a competitive procurement for a new contract for the maintenance of the system. As with other DSS-related projects, HHSDC was assigned responsibility for the procurement activities.

Request Proposes New Procurement Strategy. Since September 2000, HHSDC has been conducting the analysis and planning for the IHSS/

CMIPS competitive procurement. The budget proposes to pursue a new procurement strategy, which is intended to increase federal funding. Specifically, the administration proposes to abandon the competitive procurement approach and instead transfer the maintenance and enhancement of the IHSS/CMIPS system to the Department of Health Services' (DHS) Fiscal Intermediary (FI) contract (also with EDS). Because the DHS FI contract is funded at a higher federal funding ratio than the current IHSS/CMIPS contract, the state anticipates that its future sharing ratio of the IHSS/CMIPS costs will decrease by at least 25 percent.

DHS FI Contract Maintains Information on Medi-Cal Providers. The primary purpose of the DHS FI contract is to process both Medi-Cal and non-Medi-Cal claims submitted by entities which provide health care services. Since most IHSS providers are employed by Medi-Cal recipients, the administration believes the IHSS/CMIPS system can be included in the DHS FI contract for federal funding purposes.

Administration Requesting Approval by Federal Government. In order to transfer the IHSS/CMIPS system to the DHS FI contract, the state must first receive federal approval. In January 2004, the state submitted its request and anticipates that the federal government will complete its review before the May Revision. It is unknown if the federal government will approve the state's request. We, therefore, withhold our recommendation pending the outcome of the federal government's review.

Additional Funding for Fingerprint Project Not Justified

The budget proposes to increase the Health and Human Services Agency Data Center's (HHSDC) expenditure authority to contract for support and enhancement of the Statewide Fingerprint Imaging System. Since the proposed consultant activities are similar to activities performed by state staff on other state information technology projects, we recommend that the Legislature reduce the request by $536,000 and direct HHSDC to examine the use of state staff in lieu of consultants. (Reduce Item 4130-001-0632 by $536,000.)

Implemented in 2002, the Statewide Fingerprint Imaging System (SFIS) automates the collection, interpretation, and storage of fingerprints for persons applying for public benefits. The purpose of the system is to deter welfare and food stamp fraud. The SFIS project is the only DSS county-based project funded entirely from the General Fund. The *2003-04 Budget Act* provides $10.7 million to support and maintain SFIS. Of this amount, $453,500 is for eight state staff to manage the project. The remaining amount is for the current contractor to maintain and support the system.

Costs Were Reduced in 2003-04 but Proposed to Increase for 2004-05. The HHSDC reports that SFIS current-year costs were reduced by $2.2 million due to the implementation of technical efficiencies in the SFIS telecommunications network. For the budget year, HHSDC requests to increase its ongoing expenditure authority by (1) $536,000 to hire consultants to support the project and (2) $175,000 for future changes to the SFIS system.

Additional Consulting Activities Could Be Provided With State Staff. As noted above, state staff manages and provides technical expertise to the project. The request proposes to hire consultants to perform (1) analysis of the reprocurement for the maintenance and operation of the system, (2) analysis and testing changes to the system, and (3) project management activities. Most of these activities are similar to activities performed by state staff on other IT projects. State IT staff often cost less than consultants. For this reason, we recommend that the Legislature reduce the proposal by $536,000 and direct the administration to resubmit a request after it has examined the use of state staff. Legislative approval of a state staff proposal would require a subsequent increase in HHSDC's expenditure authority.

Employment Development Department (7100)

The Employment Development Department (EDD) is responsible for administering the Employment and Employment Related Services (EERS), the Unemployment Insurance (UI), and the Disability Insurance (DI) programs. The EERS program (1) refers qualified applicants to potential employers; (2) places job-ready applicants in jobs; and (3) helps youths, welfare recipients, and economically disadvantaged persons find jobs or prepare themselves for employment by participating in employment and training programs. Pursuant to Chapter 859, Statutes of 2002 (SB 1236, Alarcón), which implemented the Governor's Reorganization Plan Number 1, the EDD is part of the new Labor and Workforce Development Agency.

In addition, the department collects taxes and pays benefits under the UI and 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 budget proposes expenditures totaling $12.6 billion from all funds for support of EDD in 2004-05. This is a decrease $840 million or 6.2 percent below current-year estimated expenditures. This decrease is primarily due to avoiding extended benefit costs that occurred in 2003-04. The budget proposes $18.8 million from the General Fund in 2004-05, which is unchanged from the current year.

No Expenditure Plan For Discretionary Workforce Funds

The Governor's budget does not include an expenditure plan for the federal Workforce Investment Act (WIA) discretionary funds. In order to ensure that the WIA discretionary spending is consistent with legislative

priorities, we recommend denying the expenditure authority for these federal funds until an expenditure plan is submitted to the Legislature. (Reduce Item 7100-001-0869 by $16.8 million.)

Background. The federal WIA of 1998 replaced the Job Training Partnership Act, which provided employment and training services. The goal of WIA is to strengthen coordination among various employment, education, and training programs. The 63 member Workforce Investment Board (WIB) advises the Governor on the operations of the state workforce investment system; however, the board's actions are not binding on the Governor.

Pursuant to federal law, 85 percent of WIA funds (an estimated $449 million in 2004-05) are allocated to local WIBs, formerly known as Private Industry Councils. The remaining 15 percent of WIA funds ($67 million) is available for discretionary purposes such as administration, statewide initiatives, current employment service programs, or competitive grants.

Legislative Authority. Although federal law and the Governor's budget refer to these 15 percent monies as "Governor's discretionary" funds, this nomenclature is misleading. Section 191 of the WIA states that all WIA funds "shall be subject to appropriation by the State Legislature." Thus, these WIA funds should be considered *state* discretionary funds rather than Governor's discretionary funds. Accordingly, the Legislature should review the WIA expenditures to ensure their consistency with legislative priorities.

Legislature Needs Expenditure Plan. The Governor's budget includes no expenditure plan for the discretionary WIA funds. In past years, about 75 percent of the discretionary funds have been used for administration, required WIA activities, and to offset General Fund costs in existing programs. Based on this expenditure history, about $16.8 million in discretionary WIA funds should be available for proposed discretionary programs in 2004-05. Without an expenditure plan, the Legislature cannot exercise its oversight budget review responsibilities over such programs.

Analyst's Recommendation. Until the administration provides a budget plan for discretionary WIA funds, we recommend that the Legislature not appropriate these funds. Accordingly, we recommend reducing the budget authority in Item 7100-001-0869 by $16,800,000.

SETTING PRIORITIES FOR UNEMPLOYMENT ADMINISTRATION

Due to increased workload in combination with recent statewide hiring freezes, the California Unemployment Insurance Appeals Board (CUIAB) is now out of compliance with 2 of 3 federal guidelines pertaining to timely adjudication of cases, and is operating under a federal corrective action plan. CUIAB functions are primarily financed by Unemployment Administration Fund—Federal (UAFF). We recommend that CUIAB report at budget hearings on its progress in fulfilling the requirements of the federal corrective action plan and that EDD report at hearings on the competing uses of the UAFF. In addressing the workload and compliance issues at the CUIAB, the Legislature and administration should set priorities for the competing expenditure obligations for the UAFF.

Background. The CUIAB adjudicates cases involving unemployment insurance, disability insurance, and employment taxes. The EDD makes the initial determination for benefit eligibility or tax liability. The CUIAB administrative law judges conduct hearings in 12 field offices throughout the state and issue decisions on appeals of the EDD determinations. Appeals of the administrative law judge decisions are reviewed by members of the CUIAB.

For 2004-05, the Governor's budget proposes expenditures of $585 million from the UAFF, including $61.5 million for the CUIAB, $177 million for employment services, and $347 million for tax collections and benefit payments administration. Just under 90 percent of CUIAB activities are funded by UAFF.

Workload Increase/Federal Compliance. Recent increases in statewide unemployment have lead to corresponding increases in the UI caseload and the workload at the CUIAB. Further workload increases could occur when the Legislature makes changes to UI benefits and/or tax rates in response to the UI insolvency problem (discussed later in this section). Like most state agencies, the CUIAB is subject to the statewide hiring freeze, and has had limited success in receiving hiring and promotion exemptions from the Department of Finance. Currently, the CUIAB has 126 vacant positions (37 permanent and 89 temporary). As a result, the CUIAB is now out of compliance with two of three federal guidelines pertaining to timely adjudication of cases and is operating under a federally approved corrective action plan.

Competing Priorities for Federal Funds. The UAFF supports the CUIAB as well as other administrative functions at EDD. Any funds not spent in 2003-04 may be carried over to future years. In past years EDD, has used funds from a one-time Reed Act distribution (see the EDD sec-

tion of the *Analysis of 2003-04 Budget Bill* for more information on Reed Act funds) to support administrative costs at EDD, thus relieving pressure on the UAFF. Now that the Reed Act funds have been spent, the UAFF may be needed for other EDD programs formerly supported by Reed Act funds.

Analyst's Recommendation. We recommend that CUIAB report at budget hearings on its backlog and its progress in fulfilling the requirements of the federal corrective action plan. We further recommend that EDD report at hearings on the competing needs in other EDD programs for support from the UAFF. In deciding whether to commit more UAFF to the CUIAB, the Legislature needs to weigh the potential benefits of reducing the adjudication backlog at the CUIAB against potential service reductions in other EDD programs.

RESTORING SOLVENCY TO THE UNEMPLOYMENT INSURANCE FUND

The Unemployment Insurance (UI) Fund will become insolvent in the first quarter of 2004. Absent corrective action, the UI fund will develop a shortfall of $1.2 billion by the end of calendar 2004, rising to $2.3 billion by the end of 2005. Despite the estimated deficit, a recently approved federal loan will enable the fund to make required benefit payments without interruption to UI claimants in the near term. The deficit resulted from a combination of recently enacted benefit increases and higher levels of unemployment associated with the recession. We recap recent changes in the UI program and present alternatives for restoring the UI fund to solvency.

Background

Overview. The UI program is a federal-state program, authorized in federal law but with broad discretion for states to set benefit and employer contribution levels. The program is financed by unemployment tax contributions paid by employers for each covered worker. The UI program provides weekly unemployment insurance payments to eligible workers who lose their jobs through no fault of their own. To be eligible for benefits, a claimant must be able to work, be seeking work, and be willing to accept a suitable job.

Program Financing. Employers pay unemployment taxes on up to $7,000 in wages paid to employees. The actual tax rate for each employer depends on the past utilization of the UI program by the employer's workers. Current law establishes a series of contribution rate schedules

ranging from A to F, with each rate schedule tied to various potential conditions of the UI fund. Schedule A (with the lowest employer contribution rates) is used when the fund condition is most healthy and Schedule F (with the highest contribution rates) is used when the fund condition is weak (approaching a deficit). The specific rate paid by each employer depends on the record of its employees in claiming UI benefits. This record is known as an "experience rating." Cyclical employers (such as construction) pay at the higher end of each rate schedule, while employers with more steady employment (such as retail trade) pay at the lower end of the schedules.

When the economy is healthy and unemployment is low, the UI fund balance tends to increase and lower rate schedules, such as A, are typically used to determine specific tax liabilities. When the economy softens and unemployment rises, the UI fund condition tends to deteriorate resulting in the use of higher tax rate schedules such as E and F. When the fund is under extreme distress, current law authorizes Schedule "F+" which includes a 15 percent surcharge above the rates established in Schedule F.

Statutory Benefit Level. State law establishes benefit levels to be paid to unemployed workers. The current maximum weekly benefit is $410. The amount of benefits available is based on the claimant's earnings in the "base period" which is 12 months. The quarter within the base period in which the highest wages were received generally determines the weekly benefit amount. To qualify for benefits in California, a claimant must have generally earned at least $1,300 in the highest quarter of the base period.

Recent Legislative History. From 1992 through the 2001, the maximum weekly benefit for UI was $230 for 26 weeks. Benefits were also limited to 39 percent of wages earned (referred to as wage replacement) in the base period, subject to the cap of $230. Chapter 409, Statutes of 2001 (SB 40, Alarcón), provided for a total increase in the maximum weekly benefit of $220 phased in over a four-year period. Specifically, the maximum weekly benefits were scheduled to increase each January as follows: 2002—$330; 2003—$370; 2004—$410; and 2005—$450. Chapter 409 also increased wage replacement from 39 percent to 45 percent effective January 2002, and to 50 percent effective January 2003. Subsequently, Chapter 4xxx, Statutes of 2002 (SB 2xxx, Alarcón), retroactively granted the January 2002 benefit increase (to $330 per week) back to September 11, 2001.

Anticipated Impact of Chapter 409 on the UI Fund. Although Chapter 409 nearly doubled the maximum UI weekly benefit from $230 to $450 over a phased-in period, the legislation did not raise the taxable wage base of $7,000 per worker, nor did it increase the tax rate schedules. At

the time that Chapter 409 was enacted, EDD estimated that it would increase annual costs for the UI fund by about $1.2 billion each year when fully phased in. The expectation was that these costs would be financed by higher employer taxes pursuant to the *existing* higher tax rate schedules described above.

UI Fund Condition Deteriorates

Required Forecasts. In May and October of each year, EDD is required to report to the Legislature on the status of the UI fund. The October 2002 report indicated that the UI fund balance was declining and expected to reach a low point of just less than $1 billion during the first quarter of 2004. Although the projected decrease was of concern, the October 2002 forecast did not indicate the fund would become insolvent. This changed in the next forecast. In July 2003, EDD released its forecast (due in May) of the UI fund balance, indicating that the fund would experience a deficit during the first quarter of 2004 and would end 2004 with a shortfall of about $1.17 billion. The October 2003 forecast confirms the earlier forecast. Specifically, EDD projects that the deficit at the end of 2004 will be $1.15 billion and increase to $2.31 billion at the end of 2005. These deficits are projected to occur despite the use of the F+ tax schedule in 2004 and 2005.

Tax Rate Schedules. During 2001 and 2002, tax rate schedule C was in effect, and the average tax rate was about 2.5 percent for California employers. The October 2002 forecast indicated that Schedule D would be used in 2003 and Schedule F+ would be needed for 2004. The October 2003 forecast indicates that Schedule F+ will be needed in 2005 as well. According to EDD, the average tax rate is projected to increase to 3.1 percent in 2003 and 4.7 percent in 2004 and 2005, because of the increase to Schedule F+.

Federal Loan Means No Interruption in Benefit Payments

Federal Loan Approved. Because the UI fund was projected to become insolvent, the EDD applied for a federal loan during the fall of 2003. The federal Department of Labor (DOL) approved the loan in December 2003. The federal loan will permit California to make payments to UI claimants without interruption. The most recent data available indicate that as of June 2003, six states (including New York, Texas, and Illinois) were insolvent in their UI program and had obtained federal loans to continue benefit payments.

Repayment. Federal law specifies how such loans are to be repaid. Federal loans repaid within a federal fiscal year are generally interest

free. Federal loans longer than a federal fiscal year will generally be assessed interest charges of 6 percent per annum on the outstanding balance. The principal amount of any funds borrowed will be repaid from the UI fund once the fund is solvent. However, interest charges may not be paid out of the fund and most come from separate state sources. States must demonstrate progress toward restoring solvency to their UI fund within two years of receiving a federal loan, or the federal government may increase the administrative tax (currently 0.8 percent of the taxable wage base) authorized by the Federal Unemployment Tax Act.

Options for Restoring Solvency

In order to return the UI fund to solvency and repay the federal loan, the state essentially has four choices: (1) increase the taxable wage base; (2) increase the rate schedules (3) reduce benefit payments, or (4) some combination of the previous three options. Unemployment insurance benefit levels and tax rates are policy decisions for the Legislature. To assist the Legislature, we compare benefits and taxes in other states and present example packages of reforms that would achieve solvency.

Comparing Average Weekly Benefits. Figure 1 compares the average weekly benefit, the taxable wage base, and the maximum tax rate for the ten largest states. In the fourth quarter of 2003, California's average weekly benefit was $251, seventh among the ten largest states, $19 less than the average for the ten largest states, and about $10 less than the average for the United States. This was the latest available data from the DOL.

Comparing Taxable Wage Bases and Maximum Tax Rates. Figure 1 also shows the taxable wage base for the ten largest states. Only California and Florida have set the taxable wage base at the federal floor of $7,000. Most large states (7 of 10) have set the taxable wage between $8,500 and $9,000. In terms of nearby states, Nevada, Oregon, and Washington all have taxable wage bases above $20,000. Arizona is currently the same as California at $7,000. With respect to the maximum tax rates for employers in 2002, California's rates were among the lowest of the ten largest states.

In summary, California's average UI benefits in 2003 were below the national average and within the lower range of the ten largest states. California's taxable wage base and maximum tax rates are also relatively low. Below we present three options for consideration by the Legislature for addressing the UI fund insolvency. Each of these options assumes January 2005 implementation, is based on EDD's economic forecast, and restores solvency by 2006 (including repayment of the loan principal).

Figure 1

**Unemployment Insurance
Average Weekly Benefit and Taxable Wage Base
Ten Largest States**

State	Average Weekly Benefit[a]	Taxable Wage Base[b]	Maximum Tax Rate[c]
New Jersey	$336	$23,900	5.4%
Pennsylvania	295	8,000	9.1
Michigan	289	9,000	8.1
Illinois	279	9,000	6.8
New York	272	8,500	8.5
Texas	259	9,000	6.3
Ohio	253	9,000	6.5
California	**251**	**7,000**	**5.4**
Georgia	244	8,500	5.4
Florida	224	7,000	6.4

[a] Fourth quarter 2003, U.S. average was $261.
[b] Calendar 2003.
[c] Calendar 2002.

Option 1: Benefit Reduction With No Tax Increase. In order to make the UI fund solvent without increasing the taxable wage base from $7,000, benefits would need to be reduced to $230 (the level in 2001, prior to the benefit increases provided under Chapter 409 and Chapter 4xxx). Specifically, reducing benefits to $230 per week would reduce benefit payments by $1.8 billion in 2005 and $2.3 billion in 2006. The UI fund would achieve a positive balance in 2006, and Schedule F+ would remain in effect.

Option 2: Increase Taxable Wage Base With No Benefit Reduction. To achieve solvency while allowing the maximum weekly benefit to increase from $410 in 2004 to $450 in 2005, would require increasing the taxable wage base from $7,000 to $10,000. This would increase employer contributions by $1.3 billion in 2005 and $1.6 billion in 2006. The average cost to an employer for each employee who reaches $10,000 in taxable wages would be $466, an increase of about $140. Under this scenario, the UI fund would achieve a positive balance in 2006 and Schedule F+ would remain in effect.

Option 3: A Combination of Benefit Reductions With an Increase in the Taxable Wage Base. Under this approach, there could be any number of combinations for addressing the UI fund's insolvency. For example, the maximum weekly benefit could be reduced to $330 in 2005, the maximum wage replacement could be reduced to 45 percent, and the taxable wage base could rise to $9,000. This would increase employer contributions by $0.9 billion in 2005 and $1.1 billion in 2006. The average cost to an employer for each employee who reaches $9,000 in taxable wages would be $420, an increase of about $90. As with the previous options, solvency would be restored in 2006 and Schedule F+ would remain in effect.

Minimal Solutions. All of the above options would minimally restore solvency to the UI fund in 2006, and the projected balances for 2007 and 2008 would be far below prudent reserve levels. Federal guidelines suggest a prudent fund balance would be about $8.2 billion. Another recession could easily send the fund back into insolvency. In developing a solution, the Legislature should consider the long-term outlook for UI benefit payments, the fund condition, and the impact on employers.

What About Mid-Year Changes? The above scenarios assumed no change in benefits or taxes until January 2005. Although mid-year changes in both tax rates and benefits are possible, each poses administrative difficulties. This is especially the case with increasing the taxable wage base. Because most workers earn $7,000 prior to mid-year, employers finish paying their UI taxes for many employees. Accordingly, raising the tax rate mid-year during 2004 would be administratively cumbersome for employer accounting systems as they would need to redetermine which employees need additional tax payments. Alternatively, changing benefits mid-year would involve reprogramming and administrative costs at EDD, but the impact on employers would be minimal.

No Proposal in Governor's Budget

The Governor's budget contains no proposal for addressing the insolvency of the UI fund. The Governor's Budget Summary explains that (1) the administration is working with stakeholders from labor and business in order to develop a consensus on the issue and (2) budgetary impacts of the administration's UI solution will be included in the May Revision. Any interest payment owed to the federal government would require an appropriation, either in the *2004-05 Budget Act* or separate legislation.

Legislatively Mandated Report Not Completed. Chapter 1022, Statutes of 2002 (AB 444, Committee on Budget) required EDD to convene a stakeholders group to study alternative funding mechanisms for the UI program. Chapter 1022 required a report to the Legislature by December

31, 2003. At the time this analysis was prepared, the EDD had not submitted the report.

Conclusion

In order to return the UI fund to solvency, the Legislature must reduce UI benefits, increase UI taxes, or do some combination of both. In developing a solution, the Legislature should consider both the short- and long-term impacts on unemployed workers and employers.

CALIFORNIA ARTS COUNCIL
(8260)

The California Arts Council (CAC) was established in 1975. The mission of the CAC is to promote the arts in California. The CAC consists of 11 members, 9 appointed by the Governor (subject to Senate confirmation) and 1 each by the President pro Tempore of the Senate and the Speaker of the Assembly. Members of the council receive $100 per meeting and are reimbursed for travel and other expenses.

The budget proposes to continue current-year funding levels of $3.1 million and 19 positions in 2004-05, about one-third each from the General Fund, the Graphic Design License Plate Account (GDLPA), and federal funds.

Delete General Fund Support for Arts Council

We recommend that the remaining General Fund support of $1.1 million be deleted from the Arts Council's budget given the lack of local assistance grants. (Reduce Item 8260-001-0001 by $1.1 million.)

Department No Longer Offers Grants. In past years, the department's primary mission had been to administer grants to local and private entities for various arts projects. In 2002-03, the department spent $2.9 million ($1.9 million General Fund) in state operation funds for 33 positions to administer over $18 million ($17.4 million General Fund) in local assistance programs and grants. Last year, the Legislature reduced the department's budget to $3.1 million ($1.1 million General Fund), resulting in the elimination of all local assistance activities. Since it no longer operates local assistance programs, the department has been redefining its mission and focusing its efforts on administrative activities related to grants that had been authorized in prior years. In the current year, the number of staff was reduced to 19 positions, a 40 percent reduction. The budget proposes to continue the current-year staffing and funding levels.

Arts Council Should Seek Private Donations. The department reports that it is currently working on raising private donations to increase

available funding. We believe this is an appropriate long-term funding source. No donations, however, have been collected yet.

Workload Reduction Expected in 2004-05. The majority of the department's current workload is the administrative activities associated with grants provided to recipients in the past. We believe this workload should be completed by the end of the current year. Any other workload identified by the department could easily be paid for with its special and federal funds. Accordingly, because the work associated with past grants will be finished, we recommend that the remaining General Fund support of $1.1 million be deleted.

General Fund Not Needed for Federal Match. The department currently receives $1 million in National Endowment for the Arts (NEA) federal funds. The state is required to match these funds with its own spending. The NEA does not prohibit the use of GDLPA funds to meet the matching requirement. Assuming the department continues to receive federal funds, the use of GDLPA funds would meet federal matching requirements.

California Department of Food and Agriculture (8570)

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

The budget proposes expenditures of $267 million and 1,655 positions in 2004-05 for the department, including $111 million from the Agriculture Fund and $73 million from the General Fund. The proposed expenditures are $28 million, or 10 percent, below estimated current-year expenditures due to a variety of proposed program reductions.

New Funds for Pierce's Disease Not Needed This Year

The Pierce's Disease Control Program has a proposed reserve of $7.8 million (37 percent of expenditures) at the end of the budget year. This level of reserve is unnecessary. Consequently, we recommend that the Legislature eliminate proposed General Fund support for the program of $4.4 million and backfill with these reserve funds. (Delete Item 8570-004-0001.)

Background. In August 1999, an outbreak of Pierce's Disease, a bacteria that infects several plant species and can be particularly devastating to grape vines, was confirmed in the Temecula area in southern Riv-

erside County. The cause of the spread of the disease was due to a nonnative insect—the Glassy-Winged Sharpshooter. In response to the potential harm this disease poses to the wine grape industry, the Legislature has appropriated a total of $38 million from the General Fund to combat the spread of the disease. In addition, the federal government has provided about $42 million and the wine industry has contributed about $16 million through fee assessments. Thus, through 2003-04, $96 million has been committed to the Pierce's Disease Control Program.

Budget Proposal. The budget proposes expenditures of $20.9 million from the Pierce's Disease Management Account (PDMA) for support of the program. This is similar to program spending levels in recent years. Of this amount, the budget proposes that the General Fund provide $4.4 million (a reduction of $2 million) and federal funds provide $11.0 million. Contributions from the wine and grape industry and monies carried over from the current year would provide the remaining $5.5 million.

Account Reserve Too High. The proposed program expenditure level would leave the PDMA a reserve of $7.8 million at the end of 2004-05, about 37 percent of projected expenditures. Given the minimal variance in expenditures over the past several years, the account does not need to maintain a reserve of this magnitude. Accordingly, we recommend the $4.4 million General Fund transfer into the PDMA be eliminated. Instead, the program can use its reserve to meet it proposed expenditures. This would leave a reserve of $3.4 million at the end of 2004-05, over 15 percent of expenditures.

Position Management Fails To Provide Appropriate Oversight

In the course of our review of the department's budget, we learned that the department's management of its budgeted positions significantly deviates from standard state procedures. About half of CDFA's positions have been created at the discretion of the department—without approval of either the Legislature or the Department of Finance (DOF). While the CDFA's position management practices have been in place for several decades, our review reveals that the department's practices need major revisions. To better understand the department's approach to position management, we met with and spoke to departmental staff on a number of occasions. We also reviewed the State Administrative Manual (SAM); various state statutes; and position documents from the department, DOF, and the State Controller's Office (SCO). The department now acknowledges that some of its policies should be changed.

Why Is Position Oversight Important? In order to oversee the operations of the state, the Legislature needs accurate information about the number of staff working in state government. In recent years, the Legislature has expressed concern about the overall number of positions in state government. The Legislature has also expressed a concern about the number of these authorized positions that are held vacant and go unfilled. To address these concerns, the Legislature has taken a number of recent actions. For instance, at the start of each year, current law requires the abolishment of positions that were vacant for more than six months. In addition, the 2002-03 budget required the elimination of at least 7,000 vacant positions over two years. In the current budget, Control Section 4.10 requires the elimination of 16,000 positions in state government. Finally, the state has had a hiring freeze in place since 2001-02 to limit the growth of state employment and, in turn, reduce spending.

All of these actions rely on statewide information on departments' positions—including salaries, classifications, and whether the position is vacant. Information about positions is also necessary to know the amount of resources that the state is dedicating to implement its programs.

Below, we first describe how most state departments manage their positions. We then describe CDFA's position management practices and evaluate the department's rationale for its practices. Finally, we offer recommendations to the Legislature to improve the oversight and accountability of CDFA.

How State Departments Manage Positions

How Are Positions Authorized? Typically, if a department identifies a need for additional positions, it submits a budget request for DOF review. If DOF approves the request, it is included in the Governor's budget and submitted to the Legislature. If the Legislature authorizes the request for positions, the department begins the administrative steps necessary to establish the positions.

How Are Positions Established? The administrative guidelines to establish positions are included in the SAM. This manual, published by DOF, is a reference source for statewide policies, procedures, and regulations. According to SAM, departments are required to provide certain basic information to the SCO to appropriately establish any position. The DOF can also administratively establish positions to address any immediate needs.

How Is the Information Maintained? Upon receipt of the position information from a department, the SCO establishes the position and provides a unique identifier number. The SCO maintains a database that

tracks all these positions. This process allows the SCO to gather and maintain important information related to the position—including its salary, classification, and whether the position is vacant. Departments, DOF, and the Legislature are among the many entities that use the position information maintained by the SCO.

What Is the Blanket? Most departments have a "blanket" which they can use to fund overtime and some positions on a temporary basis. The intent of this blanket is to allow a department some flexibility to temporarily adjust staffing levels to meet the needs of its programs. Typically, a department uses its blanket to pay for overtime for existing staff or to hire temporary or seasonal help to address short-term workload. The SAM specifies that the blanket may *not* be used for permanent positions on an ongoing basis. Positions funded by a department's blanket are not established with the SCO. The SCO's database of state employment, therefore, does not include detailed information about such positions.

How CDFA Manages Positions

For about half of its positions, CDFA uses the same procedures to establish positions as other departments (described above). The remaining positions (771), however, are funded out of the department's blanket. Of these 771 positions, 273 are temporary-help positions and appear to be an appropriate use of the blanket. The remaining 499 positions are permanent civil service positions. As such, these positions violate the provisions of SAM and are not tracked by the SCO. The department has developed its own unique internal process to establish and manage these 499 permanent positions.

How Are Positions Funded? Many of the department's programs are funded by the Agriculture Fund. In these cases, the state collects fees from the agricultural industry to provide certain services and regulate the industry. For example, the milk testing program is funded through an assessment on California milk. The CDFA inspects dairies and milk processing plants to ensure that the products comply with sanitation and quality standards. Another example of such programs is the market enforcement program which enforces laws to protect against unfair business practices by producers, handlers, and processors of farm products. The Agriculture Fund is continuously appropriated. The department, therefore, can use the funds without regard to fiscal year, and the funds are not subject to an annual appropriation in the budget bill. Most of the department's 499 permanent blanket positions are funded from continuous appropriations (generally the Agriculture Fund).

How Are Positions Authorized? When CDFA seeks new positions associated with continuous appropriations, the department submits bud-

get requests to the CDFA secretary for approval. Upon approval of the secretary, the department begins to establish the positions and does not seek any approval outside of CDFA. As noted above, current regulations require that these requests be approved by DOF and then the Legislature.

How Are Positions Established? Based on the approval of the secretary, the positions are established using CDFA's internal process. The department funds these positions from its blanket. These positions are not established with the SCO and not identified in its database. While the DOF's budget documents display the total number (499) of these positions, it does not include information about their classifications or salaries.

A Closer Look at the Positions. Upon our request, the department provided its internal tracking information for its permanent blanket positions. As shown in Figure 1, the department has created positions in the manner described above in all of its program areas. Position classifications include office assistants, auditors, legal staff, and specialized technical staff. Salary levels are also varied, including one position funded at $123,000. While many positions are funded from the Agriculture Fund, our review indicates that some positions are (at least in part) funded by the General Fund.

Figure 1

CDFA Permanent Blanket Positions

(Dollars in Millions)

Program Areas	Positions	Funding
Measurement Standards	39	$2.2
Marketing Services	108	5.7
Animal Health and Safety	53	2.2
Inspection Services	169	7.5
Plant Industry	73	3.8
Administrative Services	57	3.0
Totals	**499**	**$24.4**

What Is the Department's Rationale for Its Policies?

The department acknowledges that its position management practices differ significantly from those of other state departments. The CDFA, however, provided various reasons to justify its process. The three primary reasons are discussed below.

Continuously Appropriated Funding Source. The department reports that its continuous appropriation authority to expend funds without regard to fiscal year also extends it the authority to create positions at the discretion of its secretary. This argument appears to rely on the notion that, because DOF and the Legislature do not oversee its appropriation on an annual basis, its positions are also exempt from annual review.

Quick Staffing Response Needed. The department also reports that the seasonality of the agricultural industry makes it difficult to follow the normal budget process. The CDFA asserts the ability to create positions unilaterally gives it flexibility to react to emergencies in the agricultural industry more quickly.

Industry Funded Programs. The department reports that since programs supported by the Agriculture Fund are funded through fees paid by the agricultural industry, the funds should not be subject to the typical level of legislative or DOF oversight. The state, in essence, is obligated to provide a level of service to the industry within the industry's timelines. According to CDFA, industry boards and CDFA provide sufficient oversight of these programs, funds, and positions.

Rationale for Separate Process Flawed

We have serious concerns with the rationales the department has offered for its unique personnel process.

Continuous Appropriations Require Legislative Oversight. Departments only have as much fiscal power as given to them by the Legislature. Consequently, the department needs to identify explicit language authorizing such latitude for position creation. The department, however, could not identify any such language—only language related to appropriating *funding*, not positions.

State Policy Provides for Quick Staffing. The department asserts that it needs the ability to create positions quickly to respond to the agricultural industry's seasonality and any emergencies. The normal budget process, however, already provides an easy process for the funding of seasonal staff, temporary staff, and overtime of existing staff. In fact, the department has already used this process to establish 273 such positions in its blanket to address short-term needs. Additionally, the DOF has the authority to administratively establish additional positions in the current year if needed. Other departments, such as the Department of Forestry and Fire Protection, routinely respond to emergencies (such as fires) by using temporary staff.

Special Funds Require Oversight. The fact that the department's programs are supported by special funds financed by industry fees is not

unusual. Many other state programs are special-fund supported—including numerous regulatory programs paid for by business fees—and all of these are subject to the prescribed process of legislative and DOF oversight. Ultimately, the state is accountable to taxpayers to ensure that these funds have been spent in an efficient and effective manner.

Management Practices Have Serious Deficiencies

Based on the information above, it is clear that the department has developed a process that allows it significant flexibility and authority over its own budget. The department reports that it monitors itself closely and that this "self-policing" provides appropriate oversight. We disagree and have identified serious deficiencies in the process.

Budgeting Policies Do Not Provide Complete Picture. We found that the department's policies do not provide a complete picture of its activities to the Legislature. The department reports that it does not submit budget requests to DOF and the Legislature for its complete administrative staffing needs. Instead, it submits requests for only a portion of the staff needed. The remaining staff are then established using its internal process. For example, while the Legislature might have thought it was authorizing ten new positions, the net result of an approved request might be 20 new positions. The total costs of the administrative staff are then distributed proportionally through all fund sources (including the General Fund).

Positions Not Subject to Reviews. Because the department never established these blanket positions as required by SAM, the department avoids automatically being subject to various legislative and administrative reviews. For example, since the positions are not established with the SCO, the SCO is unable to determine whether any positions are vacant. Thus, recent efforts to eliminate vacant positions throughout state government have "skipped over" CDFA's blanket positions. Likewise, CDFA's blanket positions were not automatically considered for elimination this year under Control Section 4.10. Finally, DOF would have minimal ability to monitor CDFA's hiring practices to ensure compliance with the state's hiring freeze.

The department indicates that, while not subject to position reduction actions, it typically has voluntarily created parallel systems for compliance. For instance, the department has imposed its own versions of a hiring freeze and position reduction plans. For eliminating vacant positions, CDFA reports it has chosen to double the length of time a position can be held vacant (from 6 to 12 months) before being eliminated. We note, however, that the department's position management practices allow it to internally restore any eliminated positions without external re-

view. This policy of self-policing leaves CDFA free to choose whether or not to implement any legislative mandate regarding position reductions.

Recommendations

The California Department of Food and Agriculture's management of 500 permanent positions needs significant revision. We recommend that the Legislature adopt trailer bill language to specify that the department's continuous appropriations do not exempt it from the normal position approval process. We also recommend that the department establish permanent positions with the State Controller's Office and submit budget requests through the Department of Finance and the Legislature for all of its future staffing needs. Finally, we recommend budget bill language requiring the department to report on these permanent blanket positions by December 2004.

We conclude that CDFA's position management practices are in need of significant revision. The department's rationale for managing its blanket positions is unfounded. Its current practices fail to provide an appropriate level of oversight. Consequently, we recommend that the Legislature require the following changes to ensure sufficient oversight and accountability. The CDFA acknowledges that some changes to its process are appropriate and is considering revisions to its process.

Trailer Bill to Clarify Position Authority. We recommend that trailer bill language be adopted to specify that its continuous appropriations do not exempt CDFA from the normal position approval process.

Properly Establish All Permanent Positions. We recommend that the department comply with state administrative policies and establish permanent positions with the SCO. As required by SAM, this would move all permanent positions out of its blanket. This would also allow the department's positions to be appropriately accounted for in the state's personnel database.

Department Should Submit Budget Requests. We recommend that the department submit budget requests through DOF and the Legislature for all of its future staffing needs. If the department needs to establish a permanent position in the current year, DOF may administratively establish it, as with other departments. If the position is needed for a longer period of time, a budget request should be submitted to extend it. Since the department is already submitting budget requests for all positions to its secretary, this requirement should not create new workload.

Report to the Legislature. The Legislature needs a complete assessment of the 499 existing permanent positions in the department's blanket. We therefore recommend that the Legislature adopt budget bill lan-

guage requiring the department to provide a report reviewing these positions by December 2004. The report should include (1) the positions by program, classification, and fund source and (2) a complete description of the workload for the positions.

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, the commission develops an estimate of the statewide cost of the mandated program and includes this estimate in a semiannual report. After receipt of this report, state law specifies that the Legislature appropriate funding in a "claims" bill to pay the newly approved mandates. Subsequent-year costs of the mandate are then funded through the budget, under each affected department.

Administration's Mandate Proposal

Consistent with the Legislature's intent as expressed in Chapter 228, Statutes of 2003 (AB 1756, Committee on Budget), the administration's budget plan includes no funding for mandate reimbursements. Instead, all 2004-05 mandate costs (approximately $600 million) and all unpaid mandate claims from 2003-04 and earlier (over $2 billion) would be deferred to an unknown future date. We discuss the state's growing mandate liabilities in "Part V" of the *Perspectives and Issues.*

Department of Veterans Affairs and Veterans' Homes of California (8950-8966)

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

The budget proposes total expenditures of $294 million in 2004-05. This is $10 million (3 percent) less than estimated current-year expenditures. General Fund expenditures of $61 million are proposed for the budget year, which is $4 million (6 percent) less than the estimated current-year level. Among the budget's proposals are:

- A redirection of $1.2 million from the Morale, Welfare, and Recreation Fund (funds collected from members' estates) to the General Fund to cover a portion of the state's costs.
- General Fund savings from the contracting out for food and security-related services at the Yountville home. This proposal is discussed in more detail below.

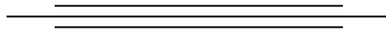
Privatization Proposal Assumes Constitutional Amendment

We withhold recommendation on a $569,000 General Fund reduction and the elimination of 120 positions for the contracting of food and security services at the Yountville home. The proposal assumes passage of a constitutional amendment that would increase the ability of the state to contract for services.

Proposal. The budget proposes a $569,000 reduction in General Fund support and the elimination of 120 positions currently providing food and security services at the Yountville home. Under the budget proposal, the state would instead contract with a private entity to provide these services. Currently, the home spends $6.7 million on these services. Thus, the proposal assumes that contracting out would save 8 percent of current costs.

Implementation Likely Depends on Constitutional Amendment. Both the Barstow and Chula Vista homes already contract out for these types of services. Unlike Yountville, they began using private contracts upon their opening. Seeking to contract out for services is easier under current constitutional provisions when not displacing state workers. Therefore, the department would face a number of hurdles under current law to now contract out for these services at the Yountville home. As discussed in the "Crosscutting Issues" section of this chapter, the administration is proposing a constitutional amendment that would expand the state's ability to contract out for such services. With such an amendment, the proposal would become more viable. Consequently, we withhold our recommendation pending the outcome of the Legislature's deliberations on the constitutional amendment.

Budget-Year Savings at Risk. The department's savings projection depends on beginning to lay off staff in July 2004. The constitutional amendment, however, would not be considered by the voters until the November 2004 ballot at the earliest. Consequently, the savings projection for the budget year is likely overstated at least by about half.



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 total 2004-05 tax relief of $4.7 billion, of which $668 million is appropriated through the budget bill. The remainder is spending on the vehicle license fee (VLF) "backfill," which is distributed to localities and funded through a continuous appropriation.

After the backfill, the second largest tax relief program is the homeowners' exemption ($433 million), which provides property tax relief to over 5 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 accommodate the expected growth in the number of homeowners claiming the exemption, the Governor's budget proposes an increase of $5.6 million, or 1.3 percent, over the amount budgeted for 2003-04.

VLF ISSUES

Vehicle License Fee Backfill

Background on the VLF. The VLF is an annual fee on the ownership of a registered vehicle in California, levied in lieu of taxing vehicles as personal property. The revenues are collected by the Department of Motor Vehicles (DMV) and distributed (after deduction of certain minor administrative expenses) to cities and counties. The rate is assessed on the depreciated value of the vehicle according to a set schedule.

Prior to 1991, all VLF revenues were available for local governments to use for general purposes. However, under the 1991 realignment plan, a new vehicle depreciation schedule was put into place and the additional revenues generated by this change were dedicated on an ongoing basis to the support of various health and social services programs subject to the state-local realignment plan. As a consequence, approximately three-fourths of VLF revenues now are general purpose revenues or "base VLF" while the remaining one-quarter is "realignment VLF."

Recent VLF Rate Reductions and Advent of Backfill. Due to the state's then-healthy budget position, the Legislature adopted in 1998 a schedule of cuts in the VLF rate, resulting in a cumulative reduction of 67.5 percent. As a result, the rate fell from the 2 percent level that had been in effect since 1948 down to 0.65 percent by 2000. In conjunction with these VLF reductions, cities and counties continued to receive the same amount of revenue that they would have under the 2 percent rate, with the reduced VLF revenues from vehicle owners replaced by General Fund revenues. Thus, the state made up the difference between what would have been raised with the 2 percent rate and the amount actually raised under the 0.65 percent rate. This spending for local government subventions is known as the General Fund backfill. Statute provides that, in the event that the state has insufficient funds to make backfill payments, such payments are to cease and a corresponding increase in the VLF rate "triggers" so that local governments are held harmless.

Backfill Eliminated and Trigger Pulled. In the January *2003-04 Governor's Budget*, the previous administration (as part of its approach to dealing with the state's budget problem) proposed eliminating the base VLF backfill to local governments while continuing the realignment VLF backfill. This would have resulted in General Fund savings in 2003-04 of approximately $3 billion and an equivalent loss to local governments. This proposal was not adopted by the Legislature.

In May 2003, the administration revised its plan, based on its assumption that there would be insufficient monies to fund the backfill, thereby triggering a VLF rate increase. In June 2003, the administration did, in fact, make a determination that there were insufficient funds for the state to continue making General Fund backfill payments to local governments. As a result, the backfill ceased as of June 20, 2003 and the VLF trigger was pulled, resulting in an increase in the VLF rate to the full 2 percent effective October 1, 2003. The "gap" period between when the backfill ceased and the increased VLF rate occurred resulted in a loss in local revenue.

Chapter 231, Statutes of 2003 (AB 1768, Oropeza), provides that lost revenues in 2003-04 would be treated as a loan from local governments

and repaid by 2006. (This language may suggest that revenue losses during the June 20 through June 30 period would *not* be treated as a loan.) The loan amount was originally estimated to be around $850 million. This was later revised to $1.3 billion by the administration, based on cashflow considerations.

Decision Reversed: VLF Rate Decreased Again. In November 2003, the current administration reversed the previous administration's determination regarding the VLF rate and lowered it once again to 0.65 percent, although no action was taken at that time regarding the General Fund backfill. In December 2003, the administration and Controller acted to pay the full General Fund backfill to local governments for the remainder of 2003-04, even though the Legislature had not provided the required appropriation authority. The Legislature's action in the *2003-04 Budget Act* limited the backfill in the current year to $1,000 regardless of the VLF rate (by "in lieuing" the continuous appropriation).

Ongoing Effects of Backfill. As a result of these administrative actions, the 2003-04 budget is expected to result in VLF backfill payments to local governments of $2.7 billion. In addition, the loan amount estimated by the administration totals $1.3 billion as discussed above. For 2004-05, the continuous appropriation will be back in effect, with backfill payments expected to total $4.1 billion.

Legislative Considerations. Given the lack of clarity and agreement over the definition of the gap period as well as the amount of the loan from local governments, the Legislature may want to address these issues in clarifying legislation. This would eliminate uncertainty for both the state and local governments regarding the gap period and its related revenues.

Local Government Hardship

We withhold recommendation on the proposal to appropriate $51 million to provide Vehicle License Fee backfill hardship payments to local governments pending the receipt of additional information from the State Controller's Office.

As part of the 2003-04 budget agreement, the Legislature sought to cushion the impact on certain local governments of their lost VLF revenues during the gap period (as discussed above). For instance, there was specific concern expressed regarding Orange County, which has dedicated VLF revenues to pay off certain bonds. Based on this situation and related concerns with other local governments, Chapter 231 provided for hardship payments under certain circumstances. While Chapter 231 expresses legislative intent to set aside $40 million for this purpose, it does

not provide an appropriation. It also does not specify whether any payments to Orange County are to be included in this amount. To the extent that the Legislature appropriates funds to provide VLF hardship payments to local governments, these payments would reduce the loan from local governments by the same amount.

Hardship Requirements. Chapter 231 established that local government hardship cases would include—but not be limited to—situations involving the following circumstances:

- The VLF has been pledged as security for the payment of debt and the nonreceipt of VLF monies will jeopardize the payment on this debt.
- The VLF constitutes 37 percent or more of the local government's general revenue.
- The local government is a city newly incorporated and is entitled to VLF revenues pursuant to statute.

Pursuant to this legislation, the State Controller's Office established an application process for the funding of such hardship situations. In addition, it included a fourth category of qualification for hardship payments—specified as "other." Chapter 231 states that monies advanced under its provisions may be paid by the Controller with the approval of the Department of Finance.

Orange County Payments. Based on its interpretation of debt service requirements relating to Orange County bonds (which the county incurred in the aftermath of its fiscal problems in the 1990s), the Controller determined that the county should receive the full VLF backfill owed to it for the gap period. Consequently, the Controller made full backfill payments to the county from the state General Fund totaling approximately $27 million. Since the Legislature has not appropriated funds for this purpose, it is not clear what appropriation authority the Controller had to make such payments. These are the only hardship payments the Controller has made to date.

Hardship Applications Mount Up. Through January 2004, the State Controller's Office has received hardship applications totaling $63 million, including an additional $9 million request from Orange County—well in excess of the $40 million originally anticipated. In addition, given that there is no date by which applications must be received, it is likely that the total requested amount will increase in the future.

However, based on the information available to us, it is not clear exactly how many of the applications relate to a "true" hardship situation. For example:

- Twenty of the 45 applications, totaling $42 million, relate to other hardships not specified by the Legislature in Chapter 231. The Legislature has not received any additional information regarding the nature of these applications.
- Applications totaling $14 million relate to the first condition specified in Chapter 231 relating to debt secured by the VLF. It is apparent, however, that some of these applications relate to short-term borrowing that, in certain cases, has already been retired.
- Our review of the dollar amounts claimed on the hardship applications indicates that they are based on the *total* backfill attributable to the gap period rather than the specific amount required to relieve hardship.

In short, it is likely that some applications do not represent specific hardships related to the lack of VLF funding, but represent instead other conditions—such as general fiscal or budgetary stress. The extent to which this is the case is not apparent at this time due to the lack of information provided to the Legislature.

LAO Recommendation. We withhold recommendation on the administration's request for an appropriation of $51 million for local government hardship situations, pending the receipt of additional information from the State Controller's Office. Specifically, the Controller should report on (1) the specific statutory and appropriation authority used to make hardship payments to Orange County, (2) the precise nature of the hardship claims filed by local governments under the "other" as well as "debt" categories, and (3) the validity of the claim amounts filed in relation to the actual amounts necessary to relieve hardship. This information would assist the Legislature in determining (1) the amount to appropriate for hardship payments (including payments to Orange County) and (2) which claims—as well as the portion of such claims—should be considered actual hardships.

Medically Indigent Adult Program

We recommend that the Legislature approve the administration's proposal to retain the current Vehicle License Fee depreciation schedule and preserve revenue support for locally realigned programs.

Background on Realignment VLF. As indicated previously, the VLF (and the corresponding General Fund backfill) is comprised of two components: (1) the base VLF and (2) the realignment VLF. The base VLF may be used by local governments for any spending purpose, while the realignment VLF is restricted to expenditures for programs associated with the 1991 realignment of various health and social services programs.

As noted, the realignment portion of the VLF is based on an adjustment to the vehicle depreciation schedule that occurred in 1991 in conjunction with the realignment of programs from state to local control. The change slowed the rate of depreciation for vehicles resulting in an increase in VLF revenues of approximately $1.5 billion annually in today's dollars.

Background on Medically Indigent Adults. In 1982, the state transferred responsibility for the Medically Indigent Adult (MIA) program within the Medi-Cal Program to the counties. The MIA pays for medical care for low-income adults, largely through clinics and hospitals. Funding for the program shift was provided by the state at roughly 70 percent of program costs. Such funding was deemed adequate since the program was not obligated to meet more expensive Medi-Cal standards of care.

Poison Pill Provisions. The 1991 realignment legislation included "poison pill" language, specifying that in the event that the courts find against the state in proceedings relating to the transfer and funding for the MIA, the depreciation schedule adopted as part of the 1991 realignment legislation would be inoperative. If this occurred, the schedule upon which the VLF is based would revert to the one that existed prior to the realignment agreement, and VLF revenues would decline by $1.5 billion.

In September 2003, the Fourth District Court of Appeals found against the state in an MIA case brought by the County of San Diego. The court said that the county expended funds for MIA activities in excess of the amounts provided by the state, and thus the program constitutes a reimbursable mandate. The state was ordered to reimburse the county $3.5 million. The state appealed the decision to the California Supreme Court, which denied the petition for review in December. There are certain administrative steps that would be required prior to the activation of the poison pill—such as notification to the DMV of the change. Nevertheless, the court action essentially starts a process that would rescind the 1991 change in the depreciation schedule.

Statutory Antidote. The administration has proposed statutory changes that would eliminate the poison pill provisions of the 1991 realignment. This proposed measure would keep in place the current programmatic structure of the realigned programs as well as their sources of funding—including the current vehicle depreciation schedule—irrespective of the final disposition of the San Diego case.

LAO's Recommendation. The 1991 realignment was predicated on the receipt of funding from the VLF and other sources to deliver health and social services at the county level. We agree with the administration's efforts to stabilize funding for these programs and are supportive of the administration's statutory proposal that would

retain the current vehicle depreciation schedule regardless of the outcome of current or future litigation.

WILLIAMSON ACT—SUBVENTIONS FOR OPEN SPACE

We recommend that the Legislature provide for the gradual elimination of payments to local governments for the local revenue losses associated with Williamson Act contracts. (Reduce Item 9100-001-0001 by $3.9 million.)

Background Information. 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 always 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.

State Role in Open Space. The continued development pressure on open space and agriculture land poses a serious policy challenge for state and local governments. Both levels of government have some role to play in designing and implementing policies that preserve a certain amount of open space, while allowing for appropriate land development and continued economic growth at the state and local levels.

The policy approach embodied in the Williamson Act subvention has the advantage of involving both levels of governments in the process, but we believe there are substantial weaknesses in the program that diminish its overall effectiveness. We have previously questioned the effectiveness of the Williamson Act subventions for several reasons. Our main concerns involve the following issues:

- The state exercises no control over the specific land parcels that are put under contract, and as such, cannot ensure that participating lands are in fact at risk in terms of development pressures.

As a consequence, it is likely that some lands under contract would not be developed even absent the Williamson Act subventions. As a result, a portion of the tax reduction may result in no behavioral change by the landowner at all.

- If such development pressures *should* occur, this results in creating incentives for the landowner to cancel or not renew the contract, both of which are options under the program (although cancellation involves meeting certain requirements). As a consequence, the program may not result in permanent changes to land use patterns but simply delay for a relatively short period of time the development of open space and agriculture lands.

Costs to State Are Substantial. The budget calls for allocating $39.8 million for city and county revenue losses due to the establishment of Williamson Act contracts. In addition, however, the state bears added costs for educational funding since reductions in assessed value also reduce the amount of property taxes flowing to schools. The school share of the property tax is approximately 52 percent; thus, the total state cost for the program is in excess of $80 million annually. Given that the open space subvention represents only a portion of the local property tax loss, it is possible that total costs to the state (subventions plus increased education funding) are substantially higher—although no statewide figures are available.

Explore Open Space Alternatives. Given the state's current budget situation and the issues associated with the Williamson Act program identified above, we do not believe an expenditure of almost $40 million for local subventions is an effective use of funds. While the state clearly has an important role to play in open space preservation, we recommend that the Legislature explore more efficient and permanent solutions to the issues related to open space and development pressures. In addition, we believe there are alternative means for open space preservation at the local level—including the direct purchase of land most at risk of development and the adoption of suitable regulatory and zoning policies.

If, however, the Legislature wishes to continue funding the Williamson Act program, there are certain measures that could be taken that would increase its efficiency and allow the state to exercise more control over its expenditures. For example, the state may wish to be a party to the contract between the local landowner and the county and thus be in a position to safeguard its interests. In addition, it may wish to make the criteria for eligibility for the program more stringent and thus help assure that only those properties genuinely "at risk" of development are allowed to participate in the program.

LAO Recommendation. We recommend that the Williamson Act subventions be phased out over time, reducing the funding for the program 10 percent per year over a ten-year period. This phase-out could be timed to coincide with the gradual increase in property taxes received by local governments as the land returns to its "normal" assessment. It would also allow the state and local governments time to implement new and more effective means of open-space preservation. This approach would save $3.9 million in 2004-05 with the full amount of annual savings realized at the conclusion of the ten-year phase-out period. In addition, DOC's administrative costs to oversee the subvention program—currently around $700,000 annually—would be gradually reduced over the phase-out period.

LOCAL GOVERNMENT FINANCING (9210)

This budget item contains funding for six purposes:

- ***Citizens' Option for Public Safety (COPS).*** The COPS program was created in 1996 to provide local governments with funds for law enforcement. The program was expanded in 2000-01 to include funding for local juvenile justice programs. The budget proposes to continue the program's funding at $200 million. We discuss the program in more detail in our discussion of the property tax shift in "Part V" of the *Perspectives and Issues* and in the "Crosscutting Issues" section of the "Judiciary and Criminal Justice" chapter of this *Analysis.*
- ***Property Tax Administration Grant Program.*** This program was created in 1995 to provide forgivable loans to counties for additional spending on property tax administration. Chapter 521, Statutes of 2001 (AB 589, Wesson), converted the program into a grant program and extended its sunset date through 2006-07. The program is expected to fund $60 million in grants for 2004-05.
- ***Special Supplemental Subventions.*** In the current year, this item provides funds to specified local governments as follows: (1) local agencies that paid county jail booking fees in 1997-98 ($38.2 million, continuously appropriated) and (2) counties with no incorporated cities on the basis that they are not eligible to receive the city portions of the gas tax and vehicle license fee distributions ($147,000). For 2004-05, the budget proposes to eliminate both these special supplemental subventions, as well as county authority to impose booking fees. We discuss booking fees in more detail below.
- ***State-Mandated Local Programs.*** Funding for ten state mandates is appropriated under this item. The administration proposes to repeal five mandates and defer payments on five mandates. We

discuss these and other state mandates in more detail in "Part V" of the *Perspectives and Issues.*

BOOKING FEES

Background

Faced with a $3.6 billion shortfall in the 1990-91 state budget, the Legislature and Governor enacted measures that significantly reduced state support for county and joint state-county programs. To mitigate a portion of the impact of these budget cuts, the Legislature enacted Chapter 466, Statutes of 1990 (SB 2556, Maddy), authorizing counties to raise revenues locally from three sources:

- Booking fees—charges imposed on cities, special districts, school districts, colleges, and universities to recover the costs associated with booking persons into the county jail.
- Property tax administration fee—charges imposed on cities and other noneducational local government agencies to offset their share of property tax administration costs.
- County taxes—authority to impose utility user and business license tax in their unincorporated areas. (In 1996, Proposition 218 made this county taxing authority subject to approval by local voters.)

Legislative materials regarding Chapter 446 suggest the Legislature intended booking fees to serve purposes beyond simple county fiscal relief. Specifically, booking fees would provide a disincentive to local agencies booking low-level offenders into county jail. This, in turn, would reduce the pressure on severely overcrowded county detention facilities and preserve county jail space for more serious offenders. Booking fees also would give cities an incentive to develop alternatives for nonviolent, less serious offenders.

Currently, most counties impose booking fees. The fee rate is determined locally, based on a county's annual costs for jail booking services and the number of bookings. In most cases, the fee is in the range of $100 to $200 per arrestee. The total amount of fees imposed statewide is unknown, but may be in the range of $40 million annually.

Booking Fee Relief. Seeking to offset local government costs associated with booking fees, but not alter the fiscal disincentives local agencies face regarding booking arrestees into county jails, the Legislature enacted a booking fee relief program with a fixed allocation formula. Under Chapter 79, Statutes of 1999 (AB 1662, Leonard)—as amended by

Chapter 1075, Statutes of 2000 (SB 225, Rainey), and Chapter 1076, Statutes of 2000 (AB 2219, Battin)—the state provides a $38.2 million continuous appropriation to annually reimburse local agencies for booking fees paid in 1997. That is, every year the state reimburses local agencies for booking fees paid in 1997; the reimbursement amount does not vary to reflect changes in the booking fee rate or the number of people booked into county jail.

Proposal

The administration proposes to eliminate the $38.2 million continuous appropriation for booking fee relief provided under Chapter 79, as well as county authority to impose booking fees under Chapter 466. The administration indicates that it will support passage of AB 1749, Committee on Budget (legislation considered, but not enacted, as part of the 2003-04 budget package), as the means to accomplish its proposal.

Analysis

The administration's proposal would reduce state costs by $38.2 million. The direct fiscal effects on local governments, in turn, would vary by agency. Local agencies that pay booking fees (principally cities) would realize net savings to the extent that their future booking fee liabilities would have exceeded their booking fee relief payment. Counties, in contrast, would experience direct revenue losses equal to the amount of booking fees that they would have charged local agencies, probably about $40 million annually.

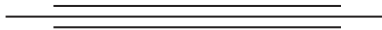
Of greater concern than the direct fiscal effects of this proposal, however, is the effect it would have on local agency fiscal incentives to minimize unnecessary bookings at county jails. Since creation of the booking fee, cities and other local agencies have taken steps to minimize their booking fee costs, including (1) creating programs such as "sobering centers" to treat people detained for public drunkenness and (2) expanding city jails. Because city jails typically house nonviolent detainees for short periods of time, they cost much less to operate than county jails. Since creation of the booking fee, the California Board of Corrections indicates that city jail space capacity has increased considerably and bookings at city jails now exceeds 400,000 arrestees annually. By eliminating the fiscal incentive to operate these city jails and alternative programs, local agencies may discontinue them and book their arrestees into county jail. County detention costs would increase accordingly.

Recommendation

Because booking fees encourage local agencies to use county booking and detention services efficiently, we recommend the Legislature reject the administration's proposal to eliminate county authority to impose booking fees, but approve the administration's proposal to end the booking fee relief program.

County authority to impose booking fees gives local agencies incentives to use county booking and detention services wisely and efficiently. Eliminating this incentive likely would result in significant increases to county costs, without any identifiable gain to public safety. Accordingly, we recommend the Legislature maintain county authority to impose booking fees.

In terms of cities, special districts, and other local agencies, we think it is appropriate that they pay for the jail booking-related costs their activities impose on counties. Such a payment requirement is analogous to many other financial arrangements among local governments, including the sharing of costs for property tax administration. In addition, we note that the $38.2 million booking fee relief program, as currently structured, allocates funding in a manner devoid of any policy rationale. We note, for example, that cities in Orange County continue to be reimbursed for their 1997 booking fee costs despite their county's decision several years ago to repeal its booking fee.



HEALTH AND DENTAL BENEFITS FOR ANNUITANTS (9650)

The state contributes toward health and dental insurance premiums for annuitants of the Judges', Legislators', District Agricultural Employees', and Public Employees' Retirement Systems, as well as specified annuitants of the State Teachers' Retirement System. Annuitants have the option of selecting from up to eight state-approved health plans depending on where an annuitant lives.

Budget-Year Costs Not Yet Completely Determined

We withhold recommendation on the $856 million General Fund request for annuitant benefits pending final determination of health insurance premium rates for calendar year 2005.

The budget proposes total expenditures of $856 million from the General Fund for health and dental benefits for annuitants in 2004-05. This is $153 million, or 22 percent, more than estimated expenditures for this purpose in the current year. This increase mainly reflects 2004 health insurance premium increases of 18 percent for basic managed care plans and almost 27 percent for Medicare managed care plans, on average. It also assumes similar changes in health insurance premiums that would go into effect January 1, 2005. Figure 1 displays General Fund expenditures for annuitant health and dental benefits for the three fiscal years starting with 2002-03. Although these costs are initially paid from the General Fund, the state recovers a portion of these costs (about 33 percent) from special funds through pro rata charges.

The actual amount needed in the budget year is dependent on negotiations over health insurance premiums currently underway between the Public Employees' Retirement System and providers. These negotiated premium rates, which will cover the 2005 calendar year, should be

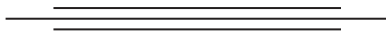
available for review during legislative budget hearings. Pending receipt of the new rates, we withhold recommendation on the amount requested under this item.

Figure 1

Health and Dental Benefits for Annuitants

(Dollars in Millions)

Program	2002-03 Actual	2003-04 Estimated	2004-05 Budgeted	Change From 2003-04 Amount	Change From 2003-04 Percent
Health	$511.9	$647.7	$796.7	$149.0	23.0%
Dental	49.0	54.9	59.4	4.5	8.2
Totals	**$560.9**	**$702.6**	**$856.1**	**$153.5**	**22.0%**



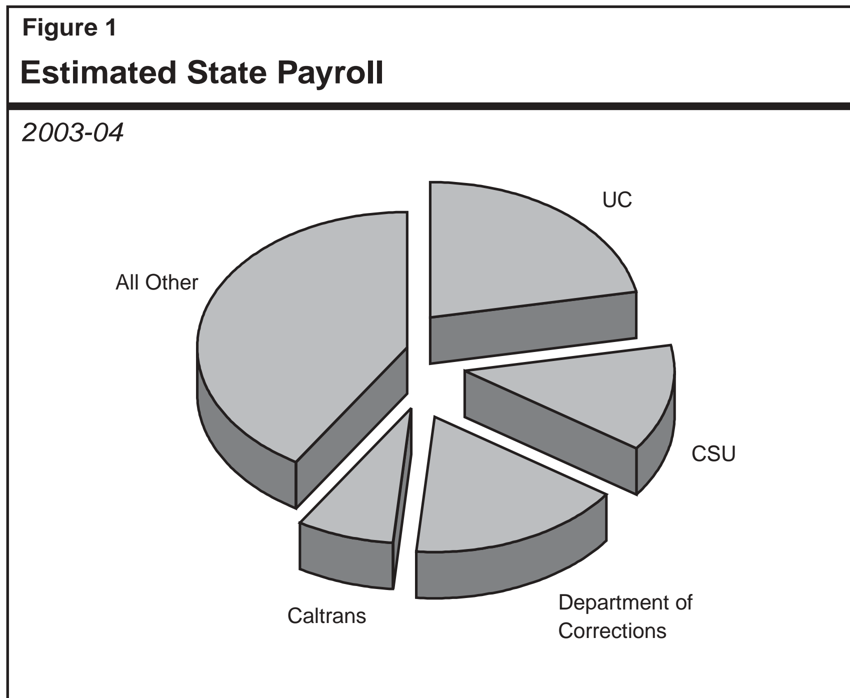
AUGMENTATION FOR EMPLOYEE COMPENSATION (9800)

A significant portion of state government's operating costs is for compensation of state employees. Figure 1 displays a breakdown of 2003-04 estimated state payroll (excluding benefits expenditures for items such as health insurance and retirement). As shown in the figure, higher education (consisting of the University of California [UC] and California State University [CSU] systems) represents approximately one-third of state employment. The Departments of Corrections and Transportation combined represent an additional one-quarter of state payroll.

Figure 1

Estimated State Payroll

2003-04



The Governor's budget projects $17 billion in salary and wage expenditures for 316,000 authorized personnel-years (PYs) in 2004-05 (including $5.9 billion and almost 113,000 PYs in higher education). In addition, the state pays for benefits such as health insurance and retirement. These additional employment costs are generally around 30 percent of salary expenditures. Thus, when benefits are included, total estimated expenditures for employee compensation are projected to approach $23 billion for the budget year, about half of which is supported from the General Fund.

Employee Pay and Benefit Increases

The budget includes $875 million ($464 million General Fund) for pay and benefit increases for collective bargaining units that negotiated contracts to delay the current-year general salary increase (5 percent for most state employees) to 2004-05 and have the state pay 80 percent of average health insurance premiums. Departments with employees of unions that did not negotiate a deferral would continue without additional funding for those employees' salary increases.

Most State Employees Scheduled for 5 Percent Salary Increase. State employees were scheduled for a salary increase on July 1, 2003. In an effort to generate 2003-04 savings, the prior administration entered into negotiations with the unions. The Legislature approved administration-negotiated agreements for 14 of the state's 21 bargaining units to defer scheduled July 1, 2003 salary increases in exchange for additional benefits. In particular, the administration agreed to (1) pay 80 percent of health insurance costs effective January 1, 2004, (2) allow employees to accrue one additional vacation day per month (approximately equivalent to the deferred 5 percent salary increase for most employees), and (3) in some cases, continue the suspension of employees' retirement contributions to maintain take-home pay at June 2003 levels. (In the future, state retirement contributions will make up the suspended employee contributions with interest. Thus, the suspension is essentially borrowing that will be paid off by the state instead of by employees.) The administration approved a similar package for supervisors, managers, and other employees not subject to collective bargaining.

Of the remaining seven bargaining units, one has reached agreement with the administration and awaits legislative approval of the proposed memorandum of understanding (MOU). The remaining six have not negotiated new contracts. The largest group that did not come to a new or revised agreement is Unit 6, which represents correctional officers. Figure 2 shows the contract status of each of the state's bargaining units.

Figure 2

Status of Memoranda of Understanding (MOUs)

Unit Number	Bargaining Unit
MOUs Approved	
1	Professional, Administrative, Financial, and Staff Services
4	Office and Allied
5	Highway Patrol
8	California Department of Forestry Firefighter
9	Professional Engineers
10	Professional Scientific
11	Engineering and Scientific Technician
14	Printing Trades
15	Allied Services
16	Physician, Dentist, and Podiatrist
17	Registered Nurse
19	Health and Social Services/Professional
20	Medical and Social Services
21	Educational Consultant and Library
MOU Pending Before Legislature	
7	Protective Services and Public Safety
MOUs in Effect, Not Renegotiated	
6	Corrections
12	Craft and Maintenance
MOUs Expired	
2	Attorneys and Hearing Officers
3	Education and Library
13	Stationary Engineer
18	Psychiatric Technician

Figure 3 (see next page) shows the recent history of general salary increases for state civil service employees and the consumer price indices for the United States and California.

Multiyear Raises for Highway Patrol and Correctional Officers. For most bargaining units, employees will receive a 5 percent salary increase (either in 2003-04 or deferred to 2004-05). The MOUs for Unit 5 and Unit 6, however, include four annual pay raises, the second of which is effective July 1, 2004. The budget-year salary increases are 7.1 percent

and 11.3 percent for Unit 5 and Unit 6, respectively. These multiyear salary increases are designed to eliminate the state's pay differential with particular local law enforcement agencies, as specified in current law. Supervisors and managers of these employees will receive a similar package. By the final pay raise effective July 1, 2006, the cumulative salary increase for employees in the two units is estimated to be one-quarter more than their 2002-03 salaries. This amount could change, however, depending on future pay increases in local law enforcement. Currently, the Department of Personnel Administration assumes just 2 percent adjustments each year for local law enforcement from 2004-05 through 2006-07. If these agencies receive higher raises, the amounts for state highway patrol and correctional officers will go up proportionately.

Figure 3

State Civil Service General Salary Increases

1991-92 Through 2004-05

Fiscal Year	State General Salary Increases	Consumer Price Indices	
		United States	California
1991-92	—	3.2%	3.6%
1992-93	—	3.1	3.2
1993-94	5.0%	2.6	1.8
1994-95	3.0	2.9	1.7
1995-96	—	2.7	1.4
1996-97	—	2.9	2.3
1997-98	—	1.8	2.0
1998-99	5.5	1.7	2.5
1999-00	4.0	2.9	3.1
2000-01	4.0	3.4	4.3
2001-02	—	1.8	3.0
2002-03	—	2.2	2.6
2003-04[a]	—[b]	1.8	2.0
2004-05[a]	5.0[c]	1.4	2.1

[a] Legislative Analyst's Office estimate of consumer price indices.

[b] Some bargaining units received a pay raise in 2003-04. In particular, correctional officers received 6.8 percent, while highway patrol officers received 2.7 percent of a scheduled 7.7 percent raise, with the remainder deferred to 2004-05.

[c] Correctional officers will receive increases of 11.3 percent. In addition to the deferred amount from 2003-04, highway patrol officers will receive a scheduled 7.1 percent increase.

Future Cost of Negotiated Pay Raises Increases Significantly. Figure 4 shows the projected ongoing cost of the negotiated general salary increases through 2006-07, when all pay raises already agreed to would be fully implemented. These costs are estimated to be $939 million in the budget year, growing to an annual cost of $1.1 billion by 2006-07. More than half of these costs are to be paid by the General Fund. As shown in the figure, a key factor driving this growth is the multiyear raises negotiated for the highway patrol and correctional officers.

Figure 4

Costs of Negotiated General Salary Increases

All Funds
(In Millions)

	2003-04	2004-05	2005-06	2006-07
Unit 5[a]	$16	$90	$127	$144
Unit 6[a]	121	390	466	532
All other	64	459	459	459
Totals	**$201**	**$939**	**$1,052**	**$1,135**

[a] Estimates include costs of related supervisorial and managerial employees.

Proposal for Employee Compensation Budget Item. In the annual budget act, Item 9800, Augmentation for Employee Compensation, includes a lump sum for any additional compensation items that take effect in the budget year. (Baseline costs are already included in department budgets.) During the fiscal year, the Department of Finance allocates to department budgets, from the lump-sum appropriation, the amounts necessary to fund these additional cost items.

The budget proposes $875 million ($464 million General Fund) for the negotiated compensation package. (This excludes higher education.) This amount includes:

- $431 million ($162 million General Fund) to pay for salary items related to the deferred pay increase.
- $138 million ($55 million General Fund) to pick up additional health, dental, and vision insurance premium costs.
- $295 million ($247 million General Fund) for the second year of raises for Unit 5 and Unit 6.

No Additional Funding for Nondeferred Current-Year Salary Increases. Employees who are members of unions that did not renegotiate their contracts received the 5 percent pay raise scheduled for July 1, 2003. Departments, however, did not receive funding for these additional costs—$201 million in the current year, as shown in Figure 4. Instead, current-year reductions adopted pursuant to Control Section 4.10 of the *2003-04 Budget Act* accounted for these costs by reducing most departments' budgets to live within existing appropriations. Under the Governor's budget, departments would continue without additional funding for these employees' pay raises already in effect. The state would also not incur any new costs for health insurance above the 2003 state contribution since these unions have not negotiated such a provision.

CONTROL SECTION 3.60

This control section specifies the contribution rates for the various retirement classes of state employees in the Public Employees' Retirement System (PERS). The section also authorizes the Department of Finance to adjust any appropriation in the budget bill as required to conform with changes in these rates. In addition, the section requires the State Controller to offset these contributions with any surplus funds in the employer accounts of the retirement trust fund.

State Contribution Rates Continue Upward . . .

Under current law, PERS is responsible for developing employer contribution rates each year based on actuarial analyses. The PERS has estimated that retirement costs would increase from the current-year level of $2.2 billion to $2.6 billion in the budget year. This includes an increase in General Fund costs of $193 million. The final determination of 2004-05 contribution rates will occur in the spring. Figure 1 (see next page) shows these rates by classification since 1991-92.

Less-Than-Assumed Return Leads to Rate Increases. This jump in state retirement contributions to PERS is primarily caused by less-than-assumed returns. The PERS' investment returns totaled just 3.9 percent for 2002-03. This follows a 6 percent loss for 2001-02 and a 7.2 percent loss for 2000-01, due primarily to the poor performance of the stock market in those years. In contrast, PERS assumes an 8.25 percent annual return over the long term for actuarial purposes.

. . . But Governor's Retirement Proposal Would Reduce 2004-05 Contributions

We withhold recommendation on 2004-05 state contribution rates for retirement benefits pending (1) the outcome of the proposed retirement package and (2) final determination of budget-year rates.

As we discuss in the "Crosscutting Issues" section of this chapter, the Governor's budget proposes to borrow funds to pay a portion of state

retirement contributions through pension obligation bonds. As a result, the state would pay $1.6 billion in retirement contributions to PERS from operating funds for 2004-05, realizing savings of $929 million in the budget year. All of these savings would accrue to the General Fund.

Figure 1

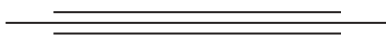
State Retirement Contribution Rates

1991-92 Through 2004-05

Fiscal Year	Misc. Tier 1	Misc. Tier 2	Industrial	Safety	Peace Officer/ Firefighter	Highway Patrol
1991-92	11.8%	4.0%	13.4%	17.4%	17.4%	21.7%
1992-93	10.3	3.4	12.0	15.7	15.6	17.1
1993-94	9.9	5.0	11.8	15.5	15.2	16.9
1994-95	9.9	5.9	10.6	13.9	12.8	15.6
1995-96	12.4	8.3	9.0	14.2	14.4	14.8
1996-97	13.1	9.3	9.3	14.7	15.4	15.9
1997-98	12.7	9.8	9.0	13.8	15.3	15.5
1998-99	8.5	6.4	4.6	9.4	9.6	13.5
1999-00	1.5	—	—	7.5	—	13.3
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[a]	16.5	11.9	13.1	23.4	23.2	35.4

[a] Public Employees' Retirement System estimates.

If the Legislature, however, does not approve the proposed retirement package, then 2004-05 contributions would rise from their present level, as noted above. As a result, pending the outcome of the proposed retirement package and final determination of 2004-05 rates, we withhold recommendation on this item.



CONTROL SECTION 4.20

The Public Employees' Retirement System (PERS) administers the health insurance program for state employees and retirees, as well as local governments that contract with PERS for this program. The budget includes $18 million in the PERS' budget for this purpose in 2004-05. To cover administrative costs, the state and contracting agencies pay a percentage of total health insurance premiums. This control section establishes the fee.

The fund that pays an employee's salary and benefits also pays the administrative fee for the health insurance program. State costs are split about evenly between the General Fund and special funds. This represents 60 percent of program revenue—30 percent each from the General Fund and special funds. Local governments make up the remaining 40 percent.

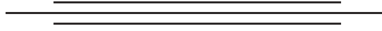
Administrative Fee Should Be Reduced

We recommend that the Legislature reduce the health insurance premium charge to 0.35 percent to accumulate a smaller fund balance and save the state $3.9 million ($1.9 million General Fund).

Recent Fee Levels. In the past, this administrative charge had been 0.5 percent of premiums, as established each year in the budget act. However, the *2002-03 Budget Act* reduced the fee to 0.2 percent to achieve General Fund savings by drawing down a very high fund balance. The *2003-04 Budget Act* returned the fee to 0.44 percent to maintain a prudent reserve while accounting for continued double-digit hikes in health insurance premiums. The current-year fee will generate an estimated fund balance of 22 percent of expenditures at the end of the current year.

Recommend Lowering Proposed Fee. The budget proposes to restore the administrative fee to 0.5 percent. This would accumulate an unnecessarily high fund balance of 50 percent by the end of the budget year. We estimate that a 0.35 percent charge would result in a more appropriate fund balance of approximately 11 percent. A 0.35 percent charge would

reduce state costs by $3.9 million ($1.9 million General Fund) while also saving local governments $2.6 million. Consequently, we recommend that the Legislature reduce the premium charge to 0.35 percent.



FINDINGS AND RECOMMENDATIONS

General Government

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Crosscutting Issues

Alternative Retirement Benefit Programs

F-17 ■ **Pension Obligation Bond.** Recommend that the Legislature reject a pension obligation bond to pay 2004-05 state retirement contributions. Courts have thus far prevented the state from issuing such bonds. Irrespective of legal issues, incurring two decades worth of debt to avoid an annual operating expense is poor fiscal policy.

F-18 ■ **Higher Contributions From Current Employees.** Gaining higher retirement contributions from current employees is an idea worth pursuing in collective bargaining. The Legislature should be aware, however, of what this provision might cost the state in return.

F-20 ■ **Pre-Chapter 555 Benefits for New Employees.** The administration proposes negotiating pre-Chapter 555 (Statutes of 1999 [SB 400, Ortiz]) retirement benefits for new employees. The state, however, could maximize savings by adopting this proposal on its own immediately, without waiting several years for full implementation.

F-21 ■ **Additional Options for Controlling Future Retirement Costs.** Recommend that the Legislature seriously

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consider the proposal to enroll new employees in pre-Chapter 555 retirement plans. Also recommend that the Legislature consider additional alternatives such as Tier 2 and defined contribution plans for all new employees. These alternatives would result in more state savings and provide other state benefits compared to the administration's proposal.

State Information Technology Projects

F-25 ■ **Assessment of State Information Technology Projects.** The results of the Department of Finance's (DOF) recent assessment of state information technology (IT) projects indicate that departments are having problems in developing their IT projects and adhering to state policies. Recommend (1) departments report on assessment results and (2) DOF reexamine certain state IT policies.

Contracting Out for State Services

F-34 ■ **Contracting Out for State Services.** We discuss the administration's proposal to amend the California Constitution to make it easier for the state to contract out for services.

Evaluating Future Economic Development Program Proposals

F-37 ■ **How Should the Legislature Evaluate Future Program Proposals?** Recommend that the Legislature require a well-researched problem, a demonstrable net benefit, and built-in evaluations when considering any future proposals for state economic development programs. This would allow the Legislature to be more certain of the effectiveness of proposed programs.

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Secretary for Business, Transportation, and Housing

F-42 ■ **General Fund Savings Possible From Film Activities. Delete Item 0520-001-0001 and Increase Reimbursements by $832,000. Transfer $1,073,000 to the General Fund.** Recommend that the Film Commission use existing statutory authority to charge fees for its film permitting activities to cover its costs, for General Fund savings of $0.8 million. Further recommend that the Legislature transfer the $1.1 million fund balance to the General Fund from the inactive Film California First program.

State Controller's Office

F-44 ■ **Fees Appropriate for the Unclaimed Property Program.** Recommend the Legislature implement a processing fee on all approved claims sufficient to cover the program's administrative costs. This would result in additional General Fund savings of $6.9 million in the budget year and $13.8 million annually thereafter.

California Gambling Control Commission

F-47 ■ **$500 Million Increased Revenue Assumption Risky.** Based on a variety of factors, the realization of $500 million in increased revenue resulting from renegotiated tribal compacts is unlikely.

F-49 ■ **Special Distribution Fund—Opportunity for General Fund Savings.** Recommend Legislature use available $137 million in the Special Distribution Fund for programs, currently funded from the General Fund, that address the impact of gambling on communities.

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Board of Equalization

F-52 ■ **Minimize Revenue Impact of Budget Cuts.** Recognize an additional $20 million in General Fund revenues. We recommend that the Legislature direct the Board of Equalization to alter its cost reduction plan in order to minimize the negative revenue impacts of such reductions.

F-54 ■ **Administrative Costs Should Be Reduced. Reduce Item 0860-001-0001 by $0.7 Million and Reimbursements by $0.3 Million.** Recommend that the Legislature reduce the budgetary authority for expenditures on professional staff retained by BOE board members.

F-54 ■ **Local Taxing Jurisdictions Should Be Self-Supporting. Reduce Item 0860-001-0001 by $1.3 Million and Increase Reimbursements by an Identical Amount.** Recommend removal of the cap on reimbursements provided by special taxing jurisdictions to BOE for its administrative expenses.

F-55 ■ **Field Office Consolidations.** Recommend that the Legislature adopt supplemental report language that would require BOE to provide information regarding costs and savings and revenue impacts of office closures and consolidations.

Secretary of State

F-57 ■ **Budget Fails to Account for Federal Election Funds.** Budget fails to account for more than $250 million in expected federal election reform funds. Recommend that the Secretary of State provide the Legislature with a proposed spending plan during the spring.

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California Science Center

F-60 ■ **Phase Out of General Fund Operational Dollars. Reduce Item 1100-001-0001 by $5 Million.** Recommend that $5 million General Fund be deleted for operational costs of the Science Center. The Science Center can access nonstate funds for these costs.

Franchise Tax Board

F-62 ■ **Abusive Tax Shelters.** Recommend the Legislature consider various steps in order to curb the use of abusive tax shelters and thereby ensure the fairness of the tax system and preserve the state's revenue base. See our discussion in *Perspectives and Issues*, "Part V."

F-63 ■ **Fees for Franchise Tax Board (FTB) Services. Reduce Item 1730-001-0001 by $3.9 Million and Increase Reimbursements by Identical Amount.** Recommend that the Legislature adopt legislation to allow the FTB to collect fees for certain special tax services currently provided free of charge to taxpayers and tax practitioners.

F-66 ■ **Revenue Acceleration and Tax Compliance Efforts.** Recommend that the FTB report at budget hearings regarding the (1) budgetary costs and estimated revenues that would result from the continuation of the department's existing revenue acceleration program, and (2) viability of a program to require tax withholding on payments to independent contractors.

F-68 ■ **District Office Consolidations and Reductions.** Recommend that the FTB report at budget hearings on district office restructuring proposals and present required

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documentation regarding the phasing in of such changes, budget savings, and revenue impacts.

Department of General Services

F-70 ■ **DGS Fails to Reduce Fees.** The Department of General Services (DGS) has not implemented required fee reductions. Adopt budget bill language that requires DGS to implement operational efficiencies and reduce fees.

F-71 ■ **Contract Savings Overstated.** The budget proposes an ongoing $100 million ($50 million General Fund) savings resulting from the renegotiation of state contracts and leases. Based on information to date, this estimate appears unrealistic. Recommend that the administration provide revised savings amounts for 2003-04 and 2004-05.

F-73 ■ **Asset Enhancement Consultant Services.** Recommend approval of $3 million and two positions, on a two-year limited-term basis, for workload related to disposing of Youth and Adult Correctional Agency property.

Department of Financial Institutions

F-74 ■ **State Law on Financial Privacy Faces Federal Preemption Issues.** Withhold recommendation on $1.9 million and 17 positions for implementation of Chapter 241, Statutes of 2003 (SB 1, Speier). There are still many unresolved issues regarding the interaction between Chapter 241 and federal law.

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Department of Corporations

F-76 ■ **State Law on Financial Privacy Faces Federal Preemption Issues.** Withhold recommendation on $1.9 million and 22 positions for implementation of Chapter 241, Statutes of 2003 (SB 1, Speier). There are still many unresolved issues regarding the interaction between Chapter 241 and federal law.

Housing and Community Development

F-78 ■ **Regional Planning Mandate Not Worth the Cost.** Recommend the elimination of the regional planning mandate since it is ineffective in encouraging the development of housing. This would save the state about $4 million annually in future liabilities.

F-81 ■ **Transfer School Facilities Fund Balance. Transfer $5.6 Million From Item 2240-115-0101.** Recommend transferring to the General Fund $5.6 million in available funds. Bond funds should be available throughout the decade to reimburse home buyers for school facility fees paid.

F-82 ■ **Shut Down Dormant Child Care Program for Savings. Transfer $721,000 From Item 2240-115-0472 and $248,000 From Item 2240-115-0474.** Recommend transferring to the General Fund $1 million from a dormant child care facility program.

Stephen P. Teale Data Center

F-84 ■ **Data Center Expenditure Authority.** Withhold recommendation on Stephen P. Teale Data Center's (TDC) expenditure authority pending receipt and review of the administration's progress report on consolidating TDC

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and the Health and Human Services Agency Data Center.

Health and Human Services Agency Data Center

F-86 ■ **Data Center Consolidation.** Withhold recommendation on Health and Human Services Agency Data Center (HHSDC) expenditure authority pending receipt and review of the administration's progress report on consolidating HHSDC and the Stephen P. Teale Data Center.

F-87 ■ **Transfer of Payroll System.** Withhold recommendation on proposal to transfer the In-Home Supportive Services/Case Management Payrolling System pending the outcome of the federal government's review.

F-88 ■ **Statewide Fingerprint Imaging System. Reduce Item 4130-001-0632 by $536,000.** Recommend reducing the request and directing HHSDC to examine the use of state staff to support the Statewide Fingerprint Imaging System in lieu of consultants.

Employment Development Department

F-90 ■ **No Expenditure Plan for Discretionary Workforce Funds. Reduce Item 7100-001-0869 by $16.8 Million.** In order to ensure that the WIA discretionary spending is consistent with legislative priorities, we recommend denying the expenditure authority for these federal funds until an expenditure plan is submitted to the Legislature.

F-92 ■ **Setting Priorities for Unemployment Administration.** In addressing the workload and compliance issues at the California Unemployment Insurance Appeals Board, the

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Legislature and administration should set priorities for the competing expenditure obligations for federal administrative funds.

F-93 ■ **Restoring Solvency to the Unemployment Insurance (UI) Fund.** Although the UI Fund will become insolvent in early 2004, a federal loan will enable the UI program to maintain benefit payments without interruption. We recap recent changes in the UI program which contributed to the deficit and present alternatives to restoring the UI fund to solvency.

California Arts Council

F-100 ■ **Delete General Fund Support. Reduce Item 8260-001-0001 by $1.1 Million.** Recommend that the remaining General Fund support be deleted from the Arts Council's budget given the lack of local assistance grants.

California Department of Food and Agriculture

F-102 ■ **General Fund Support for Pierce's Disease Not Needed This Year. Delete Item 8570-004-0001.** Recommend that the General Fund support of $4.4 million be replaced with funds from the program's reserve.

F-103 ■ **Position Management Fails to Provide Oversight.** Department's management of 500 permanent positions needs significant revision. Recommend that the Legislature adopt trailer bill language to specify that department's continuous appropriations do not exempt it from the normal position approval process. Also recommend that the department establish permanent positions with the State Controller's Office and submit budget requests through the Department of Finance and the Legislature for all of its future staffing needs. Finally,

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recommend budget bill language requiring department to report on these positions by December 2004.

Department of Veterans Affairs and Veterans' Homes of California

F-112 ■ **Privatization Proposal Assumes Constitutional Amendment.** Withhold recommendation on a $569,000 General Fund reduction from the privatization of food and security services at the Yountville home. The proposal assumes passage of a constitutional amendment that would increase the ability of the state to contract for services.

Tax Relief

F-116 ■ **Vehicle License Fee (VLF)—Local Government Hardship.** Withhold recommendation regarding administration's appropriation request. Recommend the Controller report at budget hearings regarding statutory and appropriations authority of hardship payments to date, the nature of existing local government hardship applications, and the validity of claim amounts relative to actual amounts necessary to relieve hardship.

F-118 ■ **VLF—Medically Indigent Adults.** Recommend approval of the administration's statutory proposal to retain the current vehicle depreciation schedule for VLF purposes and ensure continued funding for realigned programs.

F-120 ■ **Williamson Act Subventions. Reduce Item 9100-001-0001 by $3.9 Million**. Recommend the ten-year phase-out of Williamson Act open-space subventions.

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Local Government Financing

F-124 ■ **Booking Fees.** Because booking fees encourage local agencies to use county booking and detention services efficiently, we recommend the Legislature reject the administration's proposal to eliminate county authority to impose booking fees, but approve the administration's proposal to end the relief program.

Health and Dental Benefits for Annuitants

F-127 ■ **Budget-Year Costs Not Yet Completely Determined.** Withhold recommendation on the $856 million General Fund request for annuitant benefits pending final determination of health insurance premium rates for calendar year 2005.

Augmentation for Employee Compensation

F-130 ■ **Employee Pay and Benefit Increases.** The budget includes $875 million ($464 million General Fund) for pay and benefit increases for collective bargaining units that negotiated contracts to delay the current-year general salary increase (5 percent for most state employees) to 2004-05 and have the state pay 80 percent of average health insurance premiums. Departments with employees of unions that did not negotiate a deferral would continue without additional funding for those employees' salary increases.

Control Section 3.60

F-135 ■ **Governor's Retirement Proposal Would Reduce 2004-05 Contributions.** Withhold recommendation on 2004-05 state contribution rates for retirement benefits pending

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(1) the outcome of the proposed retirement package and (2) final determination of budget-year rates.

Control Section 4.20

F-137 ■ **Administrative Fee Should Be Reduced.** Recommend that the Legislature reduce the health insurance premium charge to 0.35 percent to accumulate a smaller fund balance and save the state $3.9 million ($1.9 million General Fund).