GENERAL GOVERNMENT

LAO

60 YEARS OF SERVICE

2005-06 Analysis

MAJOR ISSUES

General Government

☑ **State Needs Unified Strategic Approach to Homeland Security**

- The state lacks a unified strategic approach to homeland security. The Office of Homeland Security and the Department of Health Services have not sufficiently coordinated their efforts. We make a number of recommendations to address these problems, including the development of a strategic plan and annual expenditure report (see page F-13).

☑ **Governor's Data Center Consolidation Proposal Would Foreclose Legislative Oversight**

- The Governor proposes to consolidate the state's two largest data centers into the Department of Technology Services. A consolidated data center should ultimately result in improved services and reduced costs. A number of specific components of the proposal, however, would preempt the Legislature's appropriation and oversight roles. For instance, the department's expenditures would be controlled by administration officials outside the purview of the Legislature. Consequently, we recommend that the Legislature approve the consolidation but modify some key components (see page F-76).

☑ **Cost Shift to Schools Raises Short-Term and Long-Term Issues**

- The Governor proposes shifting $469 million in General Fund teacher retirement costs to school districts and/or teachers. Due to current law requirements, it is likely that the proposal would require a $469 million upward "rebenching" of

Proposition 98's minimum guarantee—nullifying the proposed General Fund savings. In addition, from a long-term perspective, the proposal on its own would not address the retirement system's shortcomings—the lack of local control and responsibility (see page F-67).

☑ Doubling the Size of the Gambling Commission Not Justified

- The budget proposes an augmentation of $4.8 million and 46 two-year limited-term positions for increased regulatory activities related to tribal gambling. The request would double the size of the California Gambling Control Commission. The request fails to (1) clearly articulate what problems are being addressed, (2) justify a new state gaming lab, and (3) reflect a joint strategy with the Department of Justice. We recommend that the Legislature reject the request and the administration resubmit a proposal which addresses these problems (see page F-31).

☑ Elections: Federal Deadline for Voter Database Approaching; Proposed Suspension of Mandates Could Cause Confusion

- The implementation of the federal Help America Vote Act of 2002 (HAVA) represents a significant opportunity for the Legislature to upgrade the state's election systems and improve the administration of election laws. At a statewide level, the most pressing HAVA deadline is the requirement to have a federally compliant voter registration database operational by January 1, 2006. We offer a number of key considerations to assist the Legislature in implementing HAVA (see page F-40).

- The Governor proposes to suspend all of the state's election-related reimbursable mandates. These suspensions would reduce the state's General Fund costs by $16.5 million in 2005-06. The suspensions, however, could cause confusion regarding election procedures and reduce statewide uniformity. We recommend funding a number of the mandates, but with a simplified reimbursement method (see page F-48).

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OVERVIEW

General Government

Total state funding for general government is proposed to decrease by about 17 percent in the budget year. This decrease primarily is due to proposed reductions in employee compensation and senior citizens property tax assistance.

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 *2005-06 Governor's Budget* proposes $5.4 billion in state expenditures (combined General Fund and special funds) for these functions. The proposed budget-year funding is $1.1 billion (17 percent) less than estimated 2004-05 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 shows the estimated 2004-05 and proposed 2005-06 expenditures by program area.

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

Figure 1

General Government Spending by Program Area

(All Funds, In Millions)

Program	Estimated 2004-05	Proposed 2005-06	Difference Amount	Difference Percent
State administration	$3,237	$3,330	$93	2.9%
Tax relief/local governments	1,260	1,173	-87	-6.9
State employee compensation[a]	2,197	1,057	-1,140	-51.9
Totals	**$6,694**	**$5,560**	**-$1,134**	**-16.9%**

a Costs not reflected in departments' budgets.

state entities. For many state departments, the Governor has proposed levels of expenditures in the budget year which are comparable to 2004-05. Spending from all funds, however, is proposed to increase about 3 percent to $3.3 billion, with General Fund spending remaining about the same as in 2004-05.

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. While most proposed budgets are similar to their 2004-05 levels, the administration proposes a $4 million (10 percent) reduction to General Fund grants administered by the Office of Emergency Services for public safety.

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

- The transfer of many functions from independent boards and commissions to existing state departments (discussed in "Part V" of *The 2005-06 Budget: Perspectives and Issues*).
- The creation of an Economic and Employment Enforcement Coalition to enforce workplace laws and restrict the underground

economy. A total of $6.5 million in funding would be provided through the Department of Industrial Relations ($3 million), the Employment Development Department ($2.5 million), and the Contractors State License Board ($1 million).

- Increased funding of $18 million for two smog programs administered by the Bureau of Automotive Repair to implement legislation enacted in 2004.
- A $5 million augmentation for the California Gambling Control Commission to increase regulatory activities related to tribal gambling.

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 $785 million ($722 million General Fund) for these two agencies in 2005-06, up roughly $38 million (5 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. Among the Governor's proposals are:

- The consolidation of the state's two primary data centers into a new Department of Technology Services (Item 1955) within the State and Consumer Services Agency.
- Funding ($1.9 million) for the development of a new state budgeting computer system.

Tax Relief and Local Government Payments

The state provides tax relief—both as subventions to local governments and as direct payments to eligible taxpayers—through a number of different programs. The major programs in this area are homeowners' property tax relief, various tax assistance programs for senior citizens, and open space property tax subventions. The Governor's budget proposes to decrease General Fund payments in this area from $668 million to $539 billion. This decrease is due to the elimination or reduction of certain tax assistance programs for seniors. The amount of tax relief in the current and budget years is well below the amount for 2003-04 due to the elimination of the Vehicle License Fee (VLF) General Fund backfill payments to local governments. Effective for 2004-05, the General Fund backfill was eliminated and the resulting local government losses replaced with increased property tax revenues. This requires additional General Fund expenditures for K-12 education. Thus, the state obligation has not changed, it instead is reflected in another program in the state budget.

State Employment and Retirement

Employment Agreements. There are about 165,000 rank-and-file state employees (not including those in higher education) covered under state collective bargaining law. The pay, benefits, and working conditions for these employees are typically spelled out in memoranda of understanding negotiated between employee unions and the state.

Funding Proposed for Increased Costs, But Savings Counted Too. The Governor's budget proposes to appropriate $261 million ($198 million General Fund) to fund existing collective bargaining agreements with costs in 2005-06. The largest component of these costs is for the final year of multiyear agreements with the California Highway Patrol and California Correctional Peace Officers Association, as well as their supervisors and managers (total costs of $198 million, of which $146 million is from the General Fund). Most other bargaining units will begin negotiating for new contracts in the spring. In negotiating new agreements, the administration seeks overall savings of $741 million ($408 million General Fund). As described in more detail below, the largest proposal would reduce the state's annual retirement payments to the Public Employees' Retirement System (PERS). The other components of the savings include:

- Authorizing the Governor to furlough state employees (not including public safety or employees providing around-the-clock care) for up to five days during times of fiscal crisis ($60 million General Fund).
- Implementing various health insurance changes ($30 million General Fund).
- Preventing time off for sick leave from counting as hours worked when determining whether overtime applies during a work period ($20 million General Fund).
- Eliminating two state holidays ($1.7 million General Fund).

Retirement Payments. The state contributes to the retirement of (1) state employees through PERS and (2) public school teachers through the

State Teachers' Retirement System (STRS). Retirement-related expenditures (from the General Fund and various special funds) account for a significant part of state spending on an annual basis. In 2005-06, General Fund expenditures for public employee retirement-related costs (excluding University of California costs) will total $3.9 billion, as shown in Figure 2. As discussed below, the Governor proposes to reduce these General Fund costs in 2005-06 by $1.5 billion.

Governor's Retirement Proposal. The administration is proposing major changes in retirement payments:

- ***Reduced Costs for Existing Employees.*** Existing state employees would have the option of (1) opting out of PERS prospectively and getting a pay raise equal to half the annual retirement cost for that year's service or (2) staying in PERS and sharing equally with the state the varying, total cost of retirement contributions each year. This would have to be bargained with employee unions. The administration estimates total net General Fund savings of $296 million from these changes.

- ***Defined Contributions for New Employees.*** The administration proposes that all newly hired employees be covered by a defined contribution retirement plan instead of the traditional defined benefit plan. The proposed 2005-06 budget does not include any estimated savings from this change since it would not start until 2007-08. (We discuss this proposal in "Part V" of *The 2005-06 Budget: Perspectives and Issues.*)

- ***STRS Shift.*** The state would shift its roughly 2 percent of payroll contribution for the teachers' base retirement program to school districts and/or teachers. This would result in General Fund savings of $469 million in 2005-06, with comparable savings in future years.

- ***Pension Bond.*** The 2004-05 budget package authorizes the issuance of a pension obligation bond. At the time of the budget's enactment, the bond was estimated to provide a General Fund benefit of $929 million in the current year. Using existing statutory authority, the administration now plans to issue the bond in 2005-06 at a somewhat lower amount ($765 million).

Figure 2

General Fund Costs for Retirement Programs[a]

(In Millions)

	Estimated 2004-05	Proposed 2005-06
State Retirement Plans		
Public Employees' Retirement	$1,401	$1,466
State Teachers' Retirement	1,149	1,050
Judges' Retirement	148	144
Defined Contribution Plans[b]	47	21
Subtotals	($2,745)	($2,681)
Other Retirement Benefits		
Health and Dental Benefits for Annuitants	$796	$861
Social Security and Medicare[c]	385	401
Subtotals	($1,181)	($1,262)
Totals	**$3,926**	**$3,943**
Proposed Budget Savings		
Proposed pension bond savings	—	-765
Proposed shift of state teachers retirement contribution to school districts	—	-469
Proposed PERS opt-out/cost-sharing for existing state employees	—	-296
Net General Fund Cost	**$3,926**	**$2,413**

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.

CROSSCUTTING ISSUES

General Government

HOMELAND SECURITY

California has received almost $900 million in federal homeland security funds, which has helped the state start addressing homeland security needs. The state, however, lacks a unified strategic approach to homeland security. In addition, only 31 percent of the state's homeland security funds have been spent to date. We make a number of recommendations on how to address these problems in the state's homeland security approach.

Background

Homeland security involves many aspects of terrorism—prevention, preparedness, response, and recovery. In 1999, the state created the State Strategic Committee on Terrorism (SSCOT), which was coordinated by the state Office of Emergency (OES) and responsible for guiding the state's preparedness and response to terrorism. In addition, the *2001-02 Budget Act* provided $562,000 from the General Fund to OES and three positions to support SSCOT's efforts. (This amount was later reduced to $284,000.) In response to the events on September 11, 2001, the state began additional homeland security efforts, discussed below.

Executive Orders Began Additional Homeland Security Activities. In October 2001, an executive order directed the SSCOT to (1) evaluate potential terrorist threats, (2) review the state's readiness to prevent and respond to terrorist threats, and (3) develop recommendations for the prevention of and response to terrorist attacks. The SSCOT was eventually disbanded because it was unable to provide the comprehensive approach to homeland security that was envisioned by the 2001 executive order. In February 2003, another executive order was issued that established the Office of Homeland Security (OHS) to coordinate the state's antiterrorism activities.

Specifically, OHS is responsible for (1) coordinating the state's antiterrorism activities, (2) acting as the state's liaison with the federal government on antiterrorism issues, and (3) coordinating the state's antiterrorism intelligence gathering and information sharing.

Expansion of Department of Health Services' (DHS) Emergency Preparedness Office (EPO). Prior to 2002, DHS' EPO was primarily responsible for coordinating public health disaster preparedness and emergency management. In 2002, the EPO was expanded to also coordinate bioterrorism preparedness at the state and local levels. (Bioterrorism is the unlawful release of toxins with the intent to intimidate or harm government entities or individuals.)

2004-05 Budget Act *Provides Positions.* Until this year, OHS operated with five staff borrowed from other departments. The *2004-05 Budget Act* provides $2 million in federal funds and 12 permanent positions for OHS. These positions are primarily for policy and coordination activities. The funding and positions are included in the OES budget. The act also provides DHS with an expansion of bioterrorism staff: (1) ten permanent positions to monitor and account for state and local expenditures and (2) 19 one-year limited-term positions for certain bioterrorism preparedness activities. In total, DHS now has 105 positions working in this area, primarily in the EPO.

State's Approach to Homeland Security

Many State and Local Agencies Involved in Homeland Security. Many agencies—at both the state and local levels—are involved in California's homeland security activities. At the state level, the primary agencies are OHS, DHS, Emergency Medical Services Authority (EMSA), California Highway Patrol (CHP), Military Department, and the Departments of Transportation, and Forestry and Fire Protection. The OHS and DHS regularly meet with these departments to coordinate the state's antiterrorism activities. At the local level, the primary agencies are the sheriffs, police, public health, fire, emergency medical services, hospitals, and other health-related agencies. At the local level, the emphasis has been on updating emergency response plans, conducting exercises, training first responders (people who are the first on the scene of an event), and purchasing personal protective equipment (PPE) and medical supplies. In addition, since 2001, state and local agencies have been involved in a number of joint homeland security related activities. For example, the Military Department, in collaboration with several different state and local agencies, has trained over 100,000 first responders on what to do in the event of a terrorist attack. The OHS, through the collaboration of various law enforcement agencies, has established the state terrorism threat assessment and early warning centers to gather intelligence and share information statewide among federal, state, and local law enforcement agencies. In addition, DHS has been able to design a statewide disease reporting system and develop a statewide network that alerts public health officials of bioterrorism events.

OHS and DHS Approve Local Grant Proposals. As summarized in Figure 1 (see next page), since 2000, the state has received almost $900 million in federal funds for five different homeland security grant programs. (Some local agencies receive additional funding directly from other federal homeland security grant programs that are not administered by the state.) Currently, OHS administers three grant programs and DHS administers the remaining two programs. Each grant program has its own set of regulations specifying the authorized recipients and use of the funds. For the most part, the funds are available for expenditure over several years and can be used for planning, training, and purchasing PPE and medical supplies. Except for the Centers for Disease Control (CDC) Bioterrorism Preparedness Grant, the federal government allows states to keep 20 percent of the grant funds and the remaining 80 percent must be provided to local agencies. (The CDC grant does not require a specific split between state and local agencies.) All grant programs allow the state's administrative agencies to keep a percentage of the funds to help administer the grants. The OHS and DHS use different methods to allocate funds to local agencies:

- ***OHS Grants to Local Agencies.*** With the exception of the Urban Areas Security Initiative, the local grant funds administered by OHS are distributed by formula to counties on a population basis. The OHS requires each county to have a committee consisting of the county public health officer, the county fire chief, a municipal fire chief, the sheriff, and a chief of police to determine the use of the grant funds within the county.
- ***DHS Grants to Local Agencies.*** Chapter 393, Statutes of 2002 (SB 406, Ortiz), establishes the procedures and requirements for the allocation and expenditure of the DHS administered grant programs. Chapter 393 establishes the local funding formula, which includes a base allotment for each jurisdiction and additional funding based on population. In addition, Chapter 393 requires each local jurisdiction to report to the state on a regular basis its grant activities and expenditures.

State Agencies Have Received Funding From Homeland Security Grants. As shown in Figure 2 (see page 17), the vast majority of the funding received by the state has been allocated to local agencies ($677 million, 78 percent of the total). Since 2001, state agencies have received about $149 million in federal homeland security funding. Figure 2 identifies the agencies that have received homeland security grant funds. Over 90 percent of these monies have gone to five state agencies: Military Department, CHP, OHS, EMSA, and DHS.

Figure 1

Federal Homeland Security Grants

2000 Through 2004

Grant Program (Federal Grant Year)	Authorized Activities	Administering Agency	Amount (In Millions)
State Domestic Preparedness Grants (2000, 2001, and 2002)	Purchasing personal protective equipment (PPE) and conducting exercises for first responders.	Office of Homeland Security (OHS)	$39.6
State Homeland Security Grants (2002, 2003, and 2004)	Planning, training, and purchasing PPE for first responder agencies.	OHS	339.8
Urban Area Security Initiative Grants (2003 and 2004)	Planning, training, purchasing PPE, and paying for overtime costs during periods of elevated threat levels for large urban areas.	OHS	203.9
Centers for Disease Control Bioterrorism Preparedness Grants (2000, 2001, 2002, 2003, and 2004)	Planning, training, and purchasing PPE and medical supplies for public health agencies.	Department of Health Services (DHS)	198.5
Health Resources and Services Agency Bioterrorism Preparedness Grants (2002, 2003, and 2004)	Planning, training, and purchasing PPE and medical supplies for the emergency medical services system; hospitals; poison control centers; and health centers.	DHS	87.5
Total			**$869.3**

Figure 2

Entities Receiving Federal Homeland Security Grant Funds

(In Thousands)

Recipients	Total
State Entities	
Air Resources Board	$350
Business, Transportation and Housing Agency	150
California State University	1,764
Conservation	150
Emergency Medical Services Authority	23,244
Environmental Protection	1,111
Food and Agriculture	1,351
Forestry and Fire Protection	4,822
General Services	492
Health and Human Services Agency Data Center	168
Health Services	43,850
Highway Patrol	32,591
Judicial Council	25
Justice	200
Mental Health	550
Military	20,224
Office of Homeland Security	14,482
Office of Planning and Research	677
Stephen P. Teale Data Center	875
Toxic Substances Control	93
Transportation	624
University of California	779
Water Resources	250
Subtotal	($148,842)
Local Agencies	$676,734
Unencumbered Grant Funds	43,692
Totals	**$869,250**

The OHS and DHS use different methods to allocate funds to state agencies:

- ***OHS Administrated Grants.*** The OHS reviews and approves grant proposals from other state agencies based on the state's annual homeland security funding priorities. In the initial years of its grants, OHS' funding priority was training and equipping state agency first responders. For future grants, OHS' funding priorities will be cyber security, agricultural terrorism, and replacing PPE.
- ***DHS Administered Grants.*** The DHS generally awards funding to the department that is the lead state entity working in a grant program's designated policy area. For example, DHS has awarded funding to EMSA to lead statewide efforts that would improve the capacity of hospitals and emergency medical systems to respond to bioterrorism events.

Unencumbered Funds. As shown in Figure 2, roughly $44 million in grants have yet to be encumbered. The administration expects that these additional funds will be encumbered by August 2005.

Budget Proposals

Budget Proposes Additional OHS Positions. For 2005-06, OHS expects to receive another $283 million for its grant programs. The January 10 budget does not include these additional federal funds. (We expect OHS to submit a proposal for the additional federal funds by the May Revision.) The budget, however, does propose $1.8 million ($1.7 million in federal funds and $100,000 from the Antiterrorism Fund) and 19 limited-term positions for OHS to manage its federal homeland security grant programs. Specifically, these new positions would (1) administer the OHS grants, (2) review and monitor existing grant activities, and (3) conduct audits to ensure that the completed activities and purchases are consistent with grant guidelines. According to OHS, due to its limited staffing, it has not been able to perform the monitoring and auditing activities.

Budget Proposes Extension of DHS Positions. The budget proposes $8.2 million in federal funds and the extension of 95 positions for two additional years. (The positions are due to expire on June 30, 2005.) The DHS has requested these positions to continue the bioterrorism preparedness activities that were initiated in prior years in areas including: (1) planning and assessment of overall preparedness, (2) surveillance and monitoring of disease outbreaks, (3) establishing a statewide network to alert local health jurisdictions, (4) education and training of public health personnel, and (5) building the capacity of health care personnel. As noted above, the current-year budget provides DHS ten positions to administer the grant funds.

President's Proposed 2006 Budget. The President's proposed 2005-06 budget includes several significant funding changes for homeland security. For example, the funding formula for providing some grants to OHS would be changed, resulting in additional funds for California. National funding for CDC grants, however, would be somewhat reduced. These changes, if adopted, generally would not affect grants received by the state until the 2006-07 state fiscal year.

State Has Started Addressing Homeland Security Needs …

The state has started addressing California's homeland security needs. The OHS and DHS have been able to distribute federal grant funds to many state and local agencies for various homeland security activities. As a result of these grant funds, state and local agencies have begun additional training of first responders. Local agencies have also been able to improve their emergency response plans, conduct more exercises, and purchase more equipment and medical supplies.

… But Lacks Unified Strategic Approach

Our review found that the Legislature has limited information about California's homeland security needs. There are several explanations why this is the case, which we discuss below.

Homeland Security Lacks a Comprehensive Plan. Most of the state's homeland security efforts to date have been directed at (1) addressing first responder and law enforcement needs (such as developing statewide intelligence systems and purchasing PPE) and (2) meeting federal grant requirements. The state is required to submit various plans detailing how the grant funds will be used. These plans are written to meet federal grant requirements, rather than offer a unified strategic approach to homeland security. For instance, in 2003, the federal government required OHS to submit a state homeland security assessment and strategy. The plan does not, however, provide a comprehensive strategy on how the state is using *all* of the state's grant funding for homeland security. For instance, it does not include how the DHS administered grants are being coordinated with the other federal grant funding to address the state's overall homeland security efforts. The strategy also does not address how homeland security preparedness and response activities assist in the state's overall emergency response and management plans (which include other types of manmade and natural disasters). Both OHS and DHS report that they are currently developing homeland security plans. At the time this analysis was prepared, it appeared that these plans would be developed independently of one another. Consequently, it is doubtful that their plans will result in a comprehensive look at the state's homeland security.

No Statewide Reporting on Homeland Security Grant Activities. The administration submits annual budget requests to the Legislature for authority to spend additional federal grant funds. These budget requests, however, do not generally describe the status of the prior-year grants, how those prior-year funds were spent, or what additional homeland security goals the administration hopes to achieve in the budget year. At the time of this analysis, DHS was able to provide only a sample of what local entities have accomplished with the federal funding. Even though Chapter 393 requires local health jurisdictions to provide regular progress reports, DHS does not generally compile this information on an aggregate basis. (The DHS indicates that it plans to compile this information in the future.) The OHS has attempted to enhance local coordination efforts for its grant programs by providing grant funds for those proposals that demonstrate cross-jurisdiction and multiple agency involvement. Other than anecdotal data, however, it is not clear how much coordination is actually occurring at the local level.

Monitoring and Audits Have Not Been Performed on Homeland Security Grants. State agencies that administer local agency grant programs are responsible for monitoring and auditing grant recipients. These activities ensure that the grant funds are being spent consistent with the approved grant proposal. In addition, monitoring and auditing helps provide information on purchases and identifies any problems that state and local agencies may be having in managing grants. As noted earlier, due to limited staffing, OHS has been unable to monitor and conduct annual audits of its grantees. The Legislature, therefore, has no detailed information on the status of its grant activities.

The DHS has implemented measures to monitor grant-funded activities at the local level. The DHS requires local health jurisdictions to submit a budget each year and provide progress reports on a regular basis in accordance with state and federal requirements. The DHS indicates that it has just begun to implement a new program coordination unit (consisting of positions funded by the 2004-05 budget) to monitor and coordinate local government activities. The department also is developing a tool to assess local jurisdictions' progress. This review and assessment tool would focus primarily on evaluating a local jurisdiction's ability to respond to public health threats as opposed to compiling a financial accounting of expenditures. In addition, DHS does not currently audit local expenditures—nor does it have plans to begin such audits. Finally, DHS does not currently audit expenditures by other state entities such as EMSA or DMH, which have received grant awards.

Future Demand for DHS Positions Uncertain. The DHS requests a two-year extension of its limited-term positions that are supported by federal bioterrorism preparedness funding. Of the requested amount, 76 positions would be funded with a bioterrorism preparedness grant which is scheduled to expire on August 30, 2005. While the federal government has indicated its intent to continue to fund these activities, information on the grant award and requirements is pending, but likely to be available this spring.

Legislative Direction Needed

Our review found that legislative policy direction of the state's homeland security efforts is needed.

Lack of Statutory Framework for OHS. To date, the state's homeland security efforts have been directed through executive orders and budget requests. The authority for OHS has been primarily provided through broader emergency authority under the Emergency Services Act (ESA). Our review, however, found that OHS and some of its specific duties (in particular the prevention of disasters) are not delineated in the ESA. Without specific statutory authority, it could be difficult for OHS to prioritize and accomplish some of its activities. For example, OHS currently relies on local agencies' cooperation to coordinate activities. There may, however, be occasions when some local agencies do not wish to participate or coordinate their activities. Currently, OHS lacks the statutory authority to *require* local agencies to participate in those activities.

Legislative Funding Priorities Have Not Been Identified. Both OHS and DHS approve state and local grant proposals. The OHS grant funding decisions are based on (1) priorities set by the administration and (2) federal government restrictions on the use of the funds. Typically, the administration has requested appropriation authority for OHS funds from the Legislature after making grant funding decisions. A better process would allow the Legislature to provide input prior to making the funding decisions.

The DHS grant funding decisions are based on priorities set by the administration and state constituency groups. In previous years, the Legislature has appropriated a portion of the grant funding through both the budget and other statutes to allow more time for DHS to work with the relevant groups to determine how funds would be spent.

Since the state's homeland security efforts lack a statutory framework, the Legislature has never established *its* priorities for the use of the grant funds. For this reason, there may be some legislative priorities on the use of these funds that are not being addressed. For example, the Legislature may consider evaluating communication systems or assessing vulnerabilities in public buildings a higher priority than some of the administration's funding priorities. Alternatively, it could decide to dedicate a larger or smaller portion of the CDC grant funds to local jurisdictions. (As noted earlier, CDC does not require a certain split of funding.)

Most of the Homeland Security Grant Funds Have Not Been Spent

In addition to the information problems noted above, several federal reviews by Congress and the U. S. Department of Homeland Security have found that many states (including California) and local agencies are having difficulties in spending specific homeland security grant funds. According to these reports, most of the spending difficulties are due to states' and local governments' procurement laws and regulations and equipment reimbursement practices. For example, some reports have found that cash-flow difficulties have slowed some local agency purchasing of expensive equipment—since the homeland security funds are provided on a reimbursement basis only. (According to OHS, the federal government recently changed this requirement and now allows states to provide the funds to local agencies prior to purchasing equipment.)

To determine the extent to which this is a problem in California, we reviewed the state's expenditure rates for homeland security grants. Figure 3 summarizes the expenditure rates for each of the five homeland security grant programs. Statewide, only 31 percent of homeland security

Figure 3

Federal Homeland Security Grant Expenditures

(Dollars in Millions)

Grant (Federal Grant Year)	Received	Spent	Remaining Balance	Percent Spent
State Domestic Preparedness Grants (2000, 2001, and 2002)	$39.7	$36.2	$3.5	91%
State Homeland Security Grants (2002, 2003, and 2004)	339.7	80.7	259.1	24
Urban Area Security Initiative Grants (2003 and 2004)	203.9	17.9	185.9	9
Centers for Disease Control Bioterrorism Preparedness Grants (2000, 2001, 2002, 2003, and 2004)	198.5	115.7	82.8	58
Health Resources and Services Agency Bioterrorism Preparedness Grants (2002, 2003, and 2004)	87.5	15.8	71.7	18
Totals	**$869.3**	**$266.3**	**$603.0**	**31%**

funds have been spent. For the OHS administered grant programs, only 23 percent of the grant funds have been spent. For its 2000 through 2002 grants, OHS has an average expenditure rate of 75 percent. The most recent 2003 and 2004 grants, however, have a much lower average expenditure rate of 18 percent. For the DHS administered grants, only 46 percent of the grant funds have been spent. The most recent grants also have a much lower average expenditure rate of 29 percent.

For both departments, it is not surprising that the more recent grants have been spent at a lower rate than those for which more time has passed. Some funds have been obligated but not yet spent. (Virtually all of OHS grant money has been encumbered, and DHS reports this is the case for more than one-third of its grant amounts.) The low expenditure rates, however, point to a statewide problem in getting the funds spent in a timely manner on their intended purposes. At the time this analysis was prepared, we were not able to determine the causes of these delays.

Recommendations to Improve State's Homeland Security Efforts

There are a number of steps that the Legislature can take to address the problems we found in the state's homeland security approach. As summarized in Figure 4, we provide the following recommendations to address the identified problems.

Enact Legislation Authorizing OHS. The OHS has existed since 2003 without specific statutory authority. This lack of statutory authority limits legislative input and prevents OHS from effectively performing some of its duties. For these reasons, we recommend that the Legislature enact legislation authorizing OHS and its specific terrorism-related duties.

Require OHS and DHS to Report at Budget Hearings on Grant Expenditures. Our review found that state and local agencies are spending the homeland security grant funds at relatively low rates. Federal reports have found that other states and local agencies experienced spending problems due to state and local procurement laws and regulations and equipment reimbursement practices. It is not clear whether these national issues or more California-specific factors are responsible for the delays. For this reason, we recommend that OHS and DHS report at budget hearings on the reasons why California's agencies are experiencing spending delays. In addition, we recommend that OHS and DHS identify any statutory changes that could increase the expenditure rates on the homeland security grants.

Require Homeland Security Strategic Plan and Annual Expenditure Report. Currently, the state does not have a comprehensive plan for homeland security. Without a plan and ongoing assessments, it is not clear how the state is maximizing the use of its federal grant funds to address overall homeland security needs. In addition, to date, the Legislature has not received any report from the administration detailing the expenditures from the homeland security grants. For these reasons, we recommend that the Legislature require OHS, in collaboration with DHS, to develop a comprehensive homeland security strategic plan and annual expenditure report. The plan should include the state's homeland security goals and objectives and an assessment of the state's level of preparedness. The annual expenditure report should identify the areas of focus for the upcoming year, the grant expenditures and coordination activities at the state and local levels that have occurred over the past year, and how those expenditures and coordination activities met the state's strategic goals and objectives.

Figure 4

LAO Recommendations to Improve Homeland Security

Problem	Recommendation
State lacks unified strategic approach to homeland security.	• Require homeland security strategic plan and annual expenditure report. • Approve budget request for increased Office of Homeland Security (OHS) staff. • Direct Department of Health Services (DHS) to expand monitoring efforts. • Withhold recommendation on extension of DHS positions.
Legislative direction needed.	• Enact legislation authorizing OHS. • Adopt budget bill language stating legislative funding priorities for the upcoming year. • Reduce Office of Emergency Services' General Fund appropriation by $284,000 to reflect that the State Strategic Committee on Terrorism is disbanded.
Most of homeland security grant funds have not been spent.	• Require OHS and DHS to report at budget hearings on grant expenditure problems.

Set Legislative Priorities for Homeland Security Funding. To date, the Legislature has not established statewide priorities for the funding of the state's homeland security activities. Without stated priorities, it is unclear whether the administration is funding activities consistent with legislative goals. For this reason, we recommend that the Legislature include language in the annual budget bill establishing broad funding goals for homeland security activities for the coming year.

Approve Request for Additional OHS Positions to Audit Grants. It is important for OHS to monitor and audit the homeland security grants to ensure that state and local agencies are spending the funds consistent with approved grant proposals. This monitoring would also provide additional information to the Legislature on the state's homeland security efforts. For this reason, we recommend that the Legislature approve the administration's request for additional staff to manage the OHS homeland security grant programs.

Direct DHS to Expand Monitoring Efforts. To date, DHS has received over $240 million in federal grant funding for various planning and coordination activities to prepare the state and local agencies against bioterrorism events. In response to concerns raised about the lack of administrative oversight of this funding, the *2004-05 Budget Act* included several financial and contract management positions to monitor local activities, provide technical assistance, and assess preparedness. These positions, however, lack an important aspect of administrative oversight—financial accounting and auditing of grant funds. Given the magnitude of funding and the significance of the effort, we recommend that the Legislature direct DHS to expand its monitoring efforts to include audits of local jurisdiction expenditures.

Withhold Recommendation on Extension of DHS Positions. There is currently some uncertainty regarding the DHS administered grants for 2005-06. By spring, DHS should have more information regarding the grant requirements and be in a better position to evaluate its staffing demands in future years. Consequently, we withhold recommendation on DHS' request for an extension of its limited-term positions.

Reduce General Fund Appropriation. As noted earlier, the Legislature provided ongoing General Fund support of the SSCOT. Since the SSCOT no longer exists and the state can use federal funds to support homeland security activities, we recommend that the Legislature reduce OES' General Fund appropriation by $284,000.

DEPARTMENTAL ISSUES

General Government

DEPARTMENT OF INSURANCE (0845)

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

The budget proposes total expenditures of $194 million for DOI in 2005-06. This is $6.1 million, or 3.2 percent, more than estimated current-year expenditures. The Insurance Fund, which supports DOI operations, derives its revenues from regulatory assessments and fees.

Insurance Fund Precariously Balanced

The department's expenditures have generally outpaced revenues in the last several years. As a result, the Insurance Fund is projected to end the budget year with a 7 percent balance—less than one month's expenditures. To reduce personal services costs in the current year, the department has instituted a hiring slowdown.

Expenditures Consistently Exceed Revenues. After relative stability from 2000-01 through 2003-04, DOI's expenditures are estimated to rise nearly $21 million, or 12 percent, in the current year to $189 million. Figure 1 (see next page) shows the recent history of the Insurance Fund. The current-year increase is due mainly to the following:

- Mostly one-time expenditures of fraud investigation funds—$12.1 million.
- Employee compensation and retirement increases—$4.1 million.

Figure 1

Insurance Fund—Expenditures Exceed Revenues

(Dollars in Millions)

	2000-01	2001-02	2002-03	2003-04	Estimated 2004-05	Proposed 2005-06
Beginning balance	$40	$37	$29	$19	$45	$31
Revenues	150	148	146	194	175	178
Total Resources	$190	$185	$175	$213	$220	$209
Expenditures	$152	$158	$160	$168	$189	$195
Ending balance	$38	$27	$15	$45	$31	$14
As percent of expenditures	25%	17%	9%	27%	16%	7%

During this period, fee and assessment revenues have not kept pace, nearly always lagging behind expenditures. This is despite two general fee increases in consecutive fiscal years—5 percent effective November 2002 and another 10 percent effective January 2004. The exception to the revenue-expenditure imbalance was 2003-04, which included the second fee increase, as well as a one-time $21 million infusion from unanticipated revenues and a General Fund loan repayment. As Figure 1 demonstrates, the revenue bump in 2003-04, followed by higher annual revenues due to the fee increases, would have sustained the fund on a more long-term basis had estimated expenditures not surged ahead of revenues again beginning in the current year.

Department Has Instituted a Hiring Slowdown. Because of the expenditure-revenue mismatch, the department has instituted a hiring slowdown for the current year. With certain exceptions under the department's policy, vacant positions must be held open for 90 days before being filled. This is to reduce personal services costs. According to the department, this delay policy would not be applied to any requested positions approved by the Legislature in the 2005-06 budget.

Proposed Budget Continues Expenditure Growth. Despite this situation, DOI's proposed budget includes a 3 percent increase in expenditures, which is in addition to the current-year's 12 percent jump. The 2005-06 increase includes $6.2 million for information technology projects plus various workload and policy proposals. As a result, the projected fund balance would be just 7 percent—less than one month—of expenditures at the end of the budget year. Furthermore, the department's proposed expenditures do not account for (1) expected retirement contribution increases or (2) pay/benefit increases that may be negotiated through collective bargaining.

The department's forecast beyond the budget year includes sustained expenditures at approximately the current-year level of $189 million (also excluding pay and benefit changes), with an ongoing $9.5 million revenue increase from existing fee and assessment sources beginning in 2006-07. It is unclear at this time, however, to what degree this additional revenue will materialize. For instance, DOI assumes an additional $3.4 million from exam fees, while acknowledging that vacancies have reduced billable hours for exams. Under the above assumptions, however, the department would maintain the 7 percent year-end balance for the next few years, with approximately equal revenues and expenditures. This outlook leaves the Insurance Fund precariously balanced even under the best-case scenario.

Because of the fund's current position, we recommend rejecting some nonessential proposals, as discussed below.

Recommend Rejecting Nonessential Proposals

We recommend that the Legislature delete $2.8 million and three positions for nonessential proposals due to the condition of the Insurance Fund. (Reduce Item 0845-001-0217 by $2.8 million.)

Due to the condition of the Insurance Fund discussed above, we recommend deleting $2.8 million in nonessential proposals. These proposals could be considered again once (1) the department realizes the expected revenue increases in future years and (2) the Insurance Fund balance stabilizes at a level higher than one-month's expenditures.

Our recommended action would delete the following requests:

- ***Consolidation of Management Information Data—$2 Million.*** The DOI proposes $2 million and two two-year limited-term positions to implement a unified management information system. This includes $1.3 million for software customization and project management. By consolidating department data, this proposal would allow DOI staff to pull together regulatory and enforcement information on the insurance industry for internal analysis and reporting purposes. Currently, information technology staff must design queries of multiple data systems for ad hoc reporting. While not ideal, the current practice can continue in the short term.

- ***Technology Refresh—$0.7 Million.*** The budget proposes an ongoing augmentation of $729,000 to replace department computers, servers, and printers on a regular cycle of three to five years, depending on the equipment. Desktop computers are enjoying longer lives, and the department has not completed a business analysis of printer needs to determine an appropriate level of funding. This type of request can be deferred to a later year.

- ***Community Investment Program—$0.1 Million.*** The DOI requests $110,000 and one position for its California Organized Investment Network (COIN) program, which matches insurance companies with investment opportunities in low-income communities. Insurance companies receive tax credits for investing in qualified projects. The COIN currently has three staff. This proposal would restore a position lost in recent reductions. With the current fund condition, this program could maintain current operations for another year without the augmentation.

Online Credit Card Payment Efficiencies Should Be Reverted

We recommend that the Legislature delete $200,000 requested for credit card charges because licensing efficiencies from online filing fully offset this cost. (Reduce Item 0845-001-0217 by $200,000.)

The DOI requests $200,000 to cover costs for the fees it pays to credit card companies for licensing transactions to apply, renew, or schedule exams. The department does not charge applicants a fee to pay by credit card. To date, the department has absorbed these costs, which grew from just $17,000 in 2002-03 to $122,000 in 2003-04. The department notes that greater use of online application and payment generates efficiencies. Specifically, online filing and scheduling has reduced processing time from six to eight weeks down to two to three weeks. According to the department, these efficiencies fully offset the cost of credit card charges. Yet, the department plans to redirect the savings to reduce backlogs in other work. These savings in staff time, however, should be used to cover the credit card costs. Consequently, we recommend the Legislature delete this request. If the department desires to address other workload, it should submit a proposal for the Legislature's consideration in the spring.

CALIFORNIA GAMBLING CONTROL COMMISSION (0855)

Established by Chapter 867, Statutes of 1997 (SB 8, Lockyer), the California Gambling Control Commission (1) monitors and enforces the terms of tribal-state gambling compacts (including the administration and distribution of funds received by the state as a result of Indian gambling 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 $13.2 million in expenditures ($10.9 million from the Indian Gaming Special Distribution Fund, and $2.3 million from the Gambling Control Fund) and 89 positions for support of the commission and its activities.

EXPANSION OF COMMISSION LACKS DETAIL AND NEEDS FURTHER CONSIDERATION

We recommend that the Legislature reject a proposal for $4.8 million and 46 positions (two-year limited-term) for increased regulatory activities related to tribal gambling. Instead, we recommend that the administration resubmit a request which distinguishes between resources for workload under the 1999 and 2004 compacts, provides justification for a state testing lab, and considers the role of the Department of Justice in regulating tribal gambling. (Reduce Item 0855-001-0367 by $4.7 million and Item 0855-001-0567 by $124,000.)

Background

Gambling on Tribal Lands. Indian tribes with tribal-state gambling compacts can operate slot machines and certain other casino-style gambling in California. Currently, 66 tribes have compacts and operate about 56,000 slot machines.

1999 Compacts. Most tribes signed their current compacts in 1999. Under these compacts, a tribe may operate up to two facilities and up to a total of 2,000 slot machines. In exchange, tribes make some payments to the state, which can only be used for specified purposes. The payments are made into two funds, the Revenue Sharing Trust Fund (RSTF) and the Special Distribution Fund (SDF). These compacts expire in 2020.

2004 Compacts. In June 2004, five tribes signed amendments to their compacts and these agreements were approved by the state. Under the amended compacts, the tribes may operate as many slot machines as they desire. In exchange, these tribes provide a combined $100 million payment annually to the state. The state plans to issue a bond backed by these revenues to repay a transportation loan obligation. The tribes provide additional payments to the General Fund for slot machines added to their facilities. These compacts expire in 2030, ten years later than the 1999 compacts. In addition, in August 2004, two tribes signed new compacts and two additional tribes amended their existing compacts. Under the provisions of these compacts, the tribes generally make payments to the state based on the "net win" of their slot machines. These agreements expire in 2025 or 2030. The Governor's budget assumes $34 million in 2005-06 General Fund revenues from the 2004 agreements.

State Agencies That Regulate Tribal Gambling. The commission and the Division of Gambling Control within the Department of Justice (DOJ) are the state's tribal gambling regulatory entities. The DOJ conducts background investigations for the commission on gambling licenses and work permit applications received by the commission. The DOJ reports that a substantial portion of its tribal law enforcement resources are spent on criminal investigations—including those involving cheating, illegal games, and illegal slot machines. The commission 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 tribal gaming activities.

Proposal

The administration proposes to increase the commission's budget by $4.8 million and 46 two-year, limited-term positions, which would result in a doubling of its current staff. Specifically, the commission requests:

- 15 auditors (which would result in a tripling of their current auditing staff) to audit financial records of the tribes to ensure that appropriate levels of payments are being remitted to the state.
- 13 state gaming testing lab and field-testing staff to test slot machines and gaming software to ensure that they are operating to acceptable standards.
- Nine licensing and investigative staff to review licenses for key employees and vendors associated with tribal gambling and to interface with law enforcement.
- 7.5 administrative staff to respond to media and provide administrative support.

The administration stated its intent to seek a supplemental appropriation to start these activities in the current year.

Administration Fails to Justify Doubling of Commission

We have several concerns with the administration's proposal, which are discussed below.

Not Clear What Problems Being Addressed. Even though the proposal is a major expansion of the commission that would result in a doubling of its size, the administration has provided little justification as to what problems would be addressed. The commission staff report that the proposal only funds activities required under the 2004 compacts. Our review, however, reveals that some of the request is for workload required under the 1999 compacts. For instance, the request includes seven auditing positions to conduct audits of payments made into the SDF. Payments are required to the SDF under the 1999 compacts, not the 2004 compacts. In reviewing the request, the Legislature needs to be able to distinguish any funding which augments existing activities from those new activities.

Assumptions Unclear. In addition, the commission was unable to provide information on the assumed level of growth in gambling in the state, which should form the basis of anticipated workload. Without these assumptions, it is difficult to evaluate the reasonableness of the requested resources.

Gaming Testing Lab Not Required. The request for 13 positions for the state gaming testing lab would commit significant state funds to an activity not required under the provisions of the compacts. The 2004 compacts require that games—prior to being operated in a casino—be tested by either an independent lab or a gaming testing lab operated by the state. Currently, new machines put into operation under the 2004 compacts are being tested by independent labs. To the extent that the state funds and operates a gaming test lab, there are no guarantees that the tribes and machine manufacturers would choose to utilize it. The commission notes some possible state advantages to a state lab, such as increased state expertise and control. The commission, however, has not fully explored the fiscal implications of developing such a lab. For instance, the proposal does not consider the possibility of minimal workload.

Poor Output From Existing Audit Staff. Currently, the commission conducts two main types of audits. One of the audits requires that staff count the machines in operation at a facility to ensure that the tribe is complying with the compact provisions related to the RSTF. The other is a financial audit to ensure that the tribe is complying with the provisions related to the payments to the SDF. The SDF compliance audits require that the commission verify that the tribe is paying a designated share of its net win. The requested additional audit positions would focus on these types of financial audits for payments to the SDF and the General Fund. Since the implementation of the 1999 compacts, the commission has completed only one financial audit of the payments made to the SDF. (The commission does note that five additional audits are underway.) Given this limited financial audit productivity from existing staff, it is difficult to determine whether additional resources would be used effectively.

Duplicative Activities Between the DOJ and the Commission. Based on our review, it appears that efficiencies could be achieved by better coordinating at least some of the activities of the DOJ and the commission. For example, the commission's audits to ensure compliance with the provisions related to RSTF payments require staff to count the number of machines in operation at the facilities. The DOJ reports that its compliance and enforcement personnel also count gaming devices to ensure the totals are within the limits specified by the compacts. These duplicative efforts result in an inefficient use of state gambling regulatory resources. Commission and DOJ staff report that there have been some past efforts to collaborate in conducting such audits. Both staffs report these collaborations were successful and helped maximize staff resources. Yet, continuing or expanding the efforts to collaborate with DOJ does not appear to have been considered in the development of the current proposal.

Recommend Commission Resubmit Improved Request

2004 Compacts Require Additional Resources. It is reasonable to expect that some level of additional commission resources is needed given the recent agreements with the tribes. These revised agreements have already resulted in an increase in the number of slot machines in operation. Moreover, required payments under the compacts directly affect the state's General Fund condition.

Recommend Resubmittal of Request. Given the current level of information available, however, we are unable to determine what level of resources are reasonable. Consequently, we recommend that the Legislature not approve the administration's current request. Instead, the administration should resubmit a request that includes the following:

- ***Which Workload Is Being Addressed?*** The request should specify what resources are intended to address workload under the 1999 compacts versus the 2004 compacts.
- ***Justify a State Gaming Testing Lab.*** The request should justify the need for a state gaming testing lab and explain how it would further the state's ability to regulate tribal gaming. The administration in developing the request should explore whether the costs of the lab could be funded from reimbursements from the manufacturers of slot machines.
- ***Reflect Strategy That Considers DOJ and the Commission.*** The request should reflect a strategic plan to regulate tribal gambling in the state, which clearly delineates areas of responsibilities and provides for appropriate coordination between DOJ and the commission.

BOARD OF EQUALIZATION
(0860)

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

The *2005-06 Governor's Budget* proposes $365 million in support of BOE operations, of which $209 million is from the General Fund with most of the remainder consisting of reimbursements from local governments. The proposed level of support represents an overall increase in funding of $6.3 million from 2004-05 levels and an increase of $1.6 million from the General Fund. The number of personnel-years for the BOE is budgeted to drop slightly from 3,648 to 3,628.

Electronic Technology Presents Advantages

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

The application of electronic technologies to tax administration has expanded rapidly over the last decade. As we indicated in our January 2005 report, *Tax Agency Consolidation: Remittance and Return Processing*, the

Employment Development Department (EDD) and FTB have increasingly converted to electronic technologies in the filing of tax returns and remittances as well as the processing of this documentation.

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

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

Electronic Documentation Is Growing. Electronically filed returns and remittances represent a growing component of tax agency processing activities. At FTB, this growth has occurred as a combined result of statutory mandates for tax practitioners as well as a "natural" migration from paper to electronic filing by individual and business taxpayers. The FTB reports that between the 2000 tax year and the 2003 tax year, electronically filed returns expanded from 2.3 million to 3.7 million, or 63 percent. Similarly, electronically filed remittance grew from 0.8 million to 1.2 million, or 47 percent. The department expects 10 percent annual growth in electronic remittances through 2008, and 5 percent to 10 percent annual growth in electronic returns through the same period.

BOE Should Plug Into Electronic Technologies. Although the BOE has made some progress in the electronic technologies and automation area, there are still substantial additional improvements that could be made. While the agency receives about 60 percent of total SUT payments through electronic funds transfer, in terms of the volume of remittances, the proportion is a fairly small share of the total. In addition, electronic tax filings (or submissions that can be scanned and converted to digital form) represent a small share of total tax returns.

As we noted in our January 2005 report, the workload at BOE tends to be largely paper-driven. Submissions of documentation is generally still conducted through paper methods and, as a result, the processing of such submissions tends to be manually intensive. Tabulations are often carried-out by hand, returns are mechanically sorted by tax program, and information is manually keyed. Much of the documentation goes through processing while still in physical—rather than digital—format.

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

While converting to electronic filing and processing would result in annual savings for the state in the medium to long term, it is also important to note that investing in electronic technologies would require up-front investment by the state. (One potential means of addressing these costs is through alternative procurement, whereby the costs of implementation are "paid" through savings achieved through the project.) Given the complexity of the issues associated with electronic filing and processing, we recommend that BOE report at budget hearings regarding its medium- to long-term goals regarding this technology, including estimates of related savings and costs.

Waste Recycling Fee Administration

We withhold recommendation on the request for additional funds to administer the Electronic Waste Recycling Fee. The Board of Equalization should report at budget hearings regarding the cost estimates for administering this fee.

To address the growing problem of electronic waste, the Legislature adopted Chapter 526, Statutes of 2003, (SB 20, Sher), which instituted a comprehensive system for the recycling or disposal of certain electronic devices. Subsequent legislation—Chapter 863, Statutes of 2004 (SB 50, Sher)—required BOE to collect the Electronic Waste Recycling Fee. The budget includes an additional $5.7 million (reimbursements and special funds) for the collection of this fee.

In terms of the other special taxes and fees that the BOE collects, the department's proposed budget appears to be on the high side. The existing Tire Recycling Fee Program provides a good comparison of costs, since, like the Electronic Waste Recycling Fee, it is collected largely from retailers. For the Tire Recycling Fee Program, the BOE has about 16 positions and collects about $32 million, or one position for every $1.9 million collected. For the Electronic Waste Recycling Fee, the BOE will have 77 positions in order to collect fees of $78 million, or one position for every $1 million collected. Although some start-up costs are expected with such a program, these seem excessive given costs associated with other special fee programs. We recommend that the BOE report at hearings regarding this proposal and provide backup regarding its cost estimates and how these can be distinguished from its program costs for existing programs.

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 $76.4 million for the SOS in 2005-06. The two primary ongoing sources of funding are the General Fund ($30.3 million) and the Business Fees Fund ($33.3 million). In addition, the current-year budget contains over $265 million in federal funds for the implementation of the Help America Vote Act of 2002 (HAVA). Below, we discuss the implementation of HAVA and the proposed suspension of all election-related mandates.

FEDERAL ELECTION REFORM

Background

Federal Election Reform. In October 2002, Congress passed and the President signed HAVA. As the state's chief elections officer, the SOS is charged with administering the state's compliance with HAVA. The past two federal budgets have provided California with a total of about $350 million to implement HAVA requirements.

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

- ***Replacement of Punch-Card Machines.*** Counties must replace their punch-card voting machines in favor of more modern technology.

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

Federal Funding

California's Share of Funding. To help states implement the HAVA requirements, the 2002-03 and 2003-04 federal budgets allocated states about $3 billion in funds. Of this amount, California is scheduled to receive over $350 million. Figure 1 (see next page) summarizes the status of California's funds, which is discussed in more detail below.

Spending Flexibility. In two cases, the federal government has provided funding for specific activities—the replacement of voting machines and disabled access. For the vast majority of the funds, however, the federal law does not mandate how much money should go to implementing each particular HAVA requirement. Rather, each state is responsible for meeting all of the requirements of federal law and may choose how to allocate the funds. While some of HAVA's requirements are fairly specific, others are much more broad. For instance, the law's requirement to educate voters on election procedures could be implemented in a wide range of ways—from providing additional information in the state voters' guide to conducting a statewide media campaign. Consequently, the state has a great deal of discretion in determining what activities should receive the highest funding priority. Federal law generally does not place restrictions on the state as to when the HAVA funds must be spent, although the law is focused on the implementation of requirements in time for elections in 2006 or earlier.

Figure 1

Status of California's HAVA Funds

(In Millions)

Category	Total Funding[a]	Commitments: Prior to 2004-05	Commitments: 2004-05	Commitments: 2005-06 Proposed	Remaining Funds
Replacement of county voting machines	$57.3	$51.1	$3.5[b]	—	$2.7
Disabled access	2.4	—	—	—	2.4
SOS administration	5.1	1.7	1.7	$1.7	—
Other HAVA activities	286.5	4.1	14.8[c]	—	267.6
Interest earnings	2.5	—	—	—	2.5
Totals	**$353.8**	**$56.9**	**$20.0**	**$1.7**	**$275.2**

a Expected total through 2005-06.

b Authorization was pending at the time this analysis was prepared.

c The *2004-05 Budget Act* appropriated $264 million for HAVA activities pending the approval of a spending plan. Of this amount, $15.2 million was authorized for expenditure for activities related to the November 2, 2004 election. The Secretary of State estimates $14.8 million will actually be spent.

2003-04 Funding

Of the HAVA funds received by the state, $81 million was authorized for expenditure by SOS in 2003-04 through a Section 28.00 request. Of these funds, $57 million was designated for counties to replace inadequate voting machines. The remaining $24 million was designated for SOS administrative costs ($1.7 million) and other activities, including voter and poll worker education ($22.2 million).

Of the $81 million authorized, the SOS reports that $57 million was actually spent. This spending is described in more detail below. The unspent funds are available for reappropriation in the current or later years. In December 2004, the Bureau of State Audits (BSA) released an audit concerning the department's administration of the HAVA funds. (The SOS reports it is still reconciling the expenditure amounts shown in the audit with its own records.)

Replacement of County Voting Machines. Regarding the funds allocated to the replacement of county voting machines, federal law specifies how the funds are to be distributed. Each precinct which used a punch-card voting system in the November 2000 election is eligible for an equal allocation of the state's $57 million. Almost 18,000 California precincts in

30 counties meet these criteria—resulting in an allocation of about $3,200 per precinct. Thus far, 16 of the counties have received their allocations (totaling $51.1 million). The SOS reports that a number of counties chose to delay their applications due to uncertainties regarding which voting machines will be certified for use. Under federal law, all counties must replace their punch-card voting machines in time for the June 2006 election.

Other 2003-04 Expenditures. In addition to the payments to counties, the SOS directly spent $5.8 million of the 2003-04 authorized amount. The SOS reports that the funds were spent on consulting services, SOS employee salaries, the printing and mailing of permanent absentee voter materials, and other administrative expenses.

2004-05 Funding

Spending Plan Required. The 2004-05 budget appropriated $264 million for HAVA activities. Prior to the expenditure of these 2004-05 funds, however, SOS is required to provide the Legislature with a spending plan for review. The 30-day review period is similar to those for Control Section 28.00 and other midyear budget requests. Prior to legislative review, the Department of Finance (DOF) must approve the plan. The spending plan must include:

- A detailed description and schedule of proposed expenditures and activities.
- Information regarding any proposed hiring of state employees or the use of consulting contracts.
- A timeline for meeting the federal HAVA requirements.
- An estimate of any costs to meet the federal requirements which exceed the appropriated funds.

The SOS has yet to have a spending plan approved by DOF.

November Election Expenditures. In early September 2004, the Legislature—through the Joint Legislative Budget Committee—approved a SOS request for $15.2 million in expenditures (from the $264 million appropriation). Although the SOS did not provide much of the budget's required information, the request was approved because the administration believed the activities were essential for the November 2004 election. The approved spending was largely for payments to counties. As described below, the SOS now estimates that $14.8 million will actually be spent on these activities.

- ***County Grants ($9.9 Million).*** These funds were allocated to 45 counties which applied to the SOS for grants. They were used for (1) voter education on voting systems, permanent absentee ballot-ing, and new voting requirements under HAVA and (2) training poll workers on HAVA requirements and the use of voting systems. Funds will be paid on a reimbursement basis. The SOS reports that it is currently reviewing requests for reimbursement from a number of counties.

- ***County Security Measures ($4.6 Million).*** On August 30, 2004, the SOS placed a number of new security requirements on counties using touch screen voting machines for the November 2004 election. For example, counties were required to make paper ballots available to those voters who prefer to use them and to provide the SOS with a technical security plan prior to the election. The SOS committed to counties that the state would cover any costs to comply with these new requirements. The SOS estimates that the costs will not exceed $4.6 million and is currently reviewing reimbursement claims from counties.
- ***Touch Screen Voting Machine Review ($690,000).*** The SOS conducted "parallel monitoring" of a sample of touch screen voting equipment in ten counties on election day to ensure the equipment was working properly ($290,000). In addition, the SOS received approval to review the computer source code used to run the equipment prior to the election ($400,000). These funds, however, were unspent after the department was unsuccessful in securing a vendor to perform the review prior to the election.

Replacement of County Voting Machines. At the time this analysis was prepared, authorization was pending to provide two additional counties with $3.5 million to replace their voting machines, leaving 12 counties who have yet to complete their applications.

Administrative Costs. In addition to the funds subject to the spending plan requirements, the Legislature approved a 2004-05 budget request to use $1.7 million in HAVA funds for administrative costs.

2005-06 Funding

Only Administrative Costs Budgeted. The Governor's budget proposes the continuation of $1.7 million for SOS administrative costs in 2005-06. The SOS expects these funds will be used to pay some or all of the salaries of 14 existing staff for HAVA-related activities—such as administering contracts, developing the required database, issuing regulations, and coordinating services for overseas and military voters. In addition, $570,000 would be used for management and information technology consulting contract costs (the largest of which is described in more detail below). Finally, the SOS has budgeted $445,000 of the total for unidentified contingencies. The budget does not include an appropriation for any additional HAVA spending, pending the determination of current-year spending and the balance of funds available.

Other Funds

Disability Grants. As shown in Figure 1, $2.4 million in HAVA grants have been earmarked to improve election accessibility and participation by disabled voters. The funds have yet to be authorized for expenditure.

Interest Earnings. Unlike for most federal programs, the state is able to keep interest earned while the HAVA funds are in state accounts. This interest must be spent on HAVA-related activities. The SOS reports that roughly $2.5 million in interest has been earned thus far. These funds are available for expenditure in 2005-06 or later years.

Recent Developments

Audits. As noted above, in December 2004, BSA completed an audit of the department's administration of HAVA funds, including testing a sample of HAVA expenditures made in 2003-04. The audit found that the SOS' insufficient planning and poor management practices hampered its efforts to implement HAVA and its disregard of controls and poor oversight of staff and consultants led to questionable uses of HAVA funds. The SOS also improperly used a Department of General Services exemption to avoid competitive bidding for many contracts paid with HAVA funds, and it failed to disburse HAVA funds to counties for the replacement of outdated voting machines within time frames outlined in its grant applications and county agreements. The SOS reports that a number of administrative changes have been implemented in an effort to address these problems. On January 27, 2005, the federal Elections Assistance Commission also ordered an audit of the state's use of its HAVA funds.

Consulting Contract Signed. In December 2004, the SOS signed a contract with a consulting firm, MGT of America, to provide assistance to the SOS in managing the HAVA program. Over the next 20 months, the $800,000 contract will provide:

- An assessment of the SOS' internal financial controls and multiple audits of expenditures.
- The development of performance measures and timetables for tasks to be completed.
- The creation of a HAVA document archive.
- Assessments of HAVA vendors.

Spending Plan. On December 2, 2004, the SOS submitted a spending plan to DOF for review. On January 4, 2005, DOF notified the SOS that it would not approve the plan due to a variety of concerns. At the time this analysis was prepared, the SOS had not yet submitted a revised plan to DOF. Consequently, the Legislature has not received a spending plan in accordance with the requirements of the 2004-05 budget. Other than the administrative and November 2004 election funds, the SOS does not currently have authority to expend HAVA funds.

Voter Database. One of the concerns cited by DOF in its review of the SOS' spending plan was that the SOS' timeline for implementation of the statewide voter registration database would not meet the federal requirement that the system be operational by January 1, 2006. The SOS' plan was to develop a new state database that would also require significant modifications of county election systems. This plan envisioned a more state-based approach than the existing county-based Calvoter database. The SOS estimated that this new system would cost $50 million to develop and $10 million annually to maintain.

The SOS has changed course and now believes that the best approach to meeting the federal timeline is to upgrade the existing Calvoter database. While the SOS is still determining the costs and timeline of its new approach, the costs should be dramatically lower than the original proposal. Based on its initial assessment, the SOS believes that the upgrades can be completed by the end of calendar year 2005—in time to meet federal requirements.

Even with this revised approach, the SOS believes that—on a longer term basis—the state will need to invest in a new database similar to its original proposal. Among the long-term concerns with the Calvoter system are:

- The state does not own the source code of the Calvoter system—making modifications and upgrades more costly.
- Even with upgrades, the Calvoter system may not have the capacity to handle the necessary data and updates.
- The county-based approach of the Calvoter system inherently limits the state from validating the accuracy of updates.

Budget-Year Spending Will Depend on Current-Year Actions

We withhold recommendation on the Help America Vote Act (HAVA) spending in the budget year, pending the receipt of a proposal from the administration. To assist the Legislature in implementing HAVA, we offer a number of key considerations.

As noted in Figure 1, the state has about $275 million in expected HAVA funds available for election-reform priorities. (Of this amount, the state is awaiting the receipt of $169 million from the federal government.) The implementation of HAVA represents a significant opportunity for the Legislature to upgrade the state's election systems and improve the administration of election laws. The funds available for appropriation in 2005-06 will depend on what level of funding is approved in the current year through a spending plan. We expect that the administration will propose an update to the SOS' budget once those decisions are made. We therefore withhold recommendation on the HAVA budget pending the receipt of a proposal in the spring. As the Legislature approaches decisions regarding spending priorities for the HAVA funds, we offer a number of key considerations below.

Review Administrative Budget in Context of Overall Spending Proposal. As noted above, the budget currently contains only the proposed $1.7 million in administrative expenditures. As the administration puts forward a spending proposal for additional SOS staff and expenditures, it will be important for the Legislature to review these administrative funds in the context of the overall spending proposal. At this point, it is difficult to evaluate the administrative needs of the department without knowing what activities it will be administering. In addition, we would expect the administration to reduce the request by $445,000 for contingencies unless additional workload is identified.

Statewide Database Requires State Priority. At a statewide level, the most pressing HAVA deadline is the requirement to have a functional voter registration database operational by January 1, 2006. As noted above, the SOS has recently switched its approach to meet this requirement. Once the SOS develops a more formal and detailed strategy for meeting this deadline, the Legislature can help to ensure that the approach offers a realistic timeline for both meeting federal requirements and ensuring an accurate database.

Furthermore, the Legislature will need to consider the merits, risks, and costs of pursuing a new statewide database over the longer term. By waiting to develop such a system until next year or later, the state should be able to build upon the experiences of other states which are currently developing such systems. Even so, developing a state-based system and successfully integrating 58 counties would be a significant undertaking. Such an undertaking would require a sizable commitment of HAVA funds—reducing the funds available for other priorities. In addition, the state will not be able to rely on HAVA funds to provide an ongoing funding source for the maintenance and operation costs of a new state system (which would likely be higher than the existing Calvoter system).

Consider Block Grant Subventions to Counties. In addition to the database, the SOS has a number of other key responsibilities in preparing for the next election—certifying voting devices for county use for instance. Likewise, as the day-to-day managers of elections, counties will be facing a series of responsibilities—such as upgrading voting equipment and educating pollworkers and voters on its use. One of the key purposes of HAVA funds is to assist counties in performing these duties. To date, these types of funds have been provided to counties on a reimbursement basis. On this basis, counties must file receipts and documentation prior to receiving grant funds. The SOS must verify the receipts and authorize payments on an item-by-item basis. Moreover, the recent BSA audit noted numerous delays by the SOS in distributing funds to counties. Consequently, as it approaches providing future HAVA funds to counties, the Legislature may wish to consider providing counties HAVA funds on a block grant basis. The key components of such an approach would be:

- ***County Responsibility.*** In accepting funds, counties would accept responsibility for meeting specific HAVA responsibilities. Counties could file an annual report detailing how the funds were used to meet these responsibilities.
- ***County Flexibility.*** The most expensive county costs will be for (1) providing a machine in each polling place for disabled access and (2) upgrading machines to provide paper records for auditing (pursuant to Chapter 814, Statutes of 2004 [SB 1438, Johnson]). We would expect most counties to focus HAVA dollars on these costs, but other possible uses could include pollworker training and public education. Under such an approach, counties could choose their highest priority for funds.
- ***Allocation Based on Formula.*** To ensure quick allocations of funds, the Controller could disburse the funds through a formula. For instance, a formula could be similar to the Proposition 41 voting modernization bond formula (which is weighted by number of voters and polling places).

SUSPENSION OF ELECTION MANDATES

Many Election Requirements Are Reimbursable State Mandates

Background. A number of the state's requirements of county election officials related to election procedures have been determined to be reimbursable state mandates. In recent budgets, most of these mandates have been "deferred"—meaning that the requirements have remained in effect and the state is still accruing liabilities for counties' compliance with the mandates, but no reimbursements to counties have been made. In addition, over the past year, the Commission on State Mandates (CSM) has determined that there are two additional election-related reimbursable mandates—related to presidential primaries and tabulating absentee ballot results by precinct.

Under the provisions of Proposition 1A passed by the voters in November 2004, the state is no longer able to defer the costs of mandates. Instead, for each mandate the state is either obligated to provide full funding in the budget or "suspend" its requirements during 2005-06. For each of the seven election-related mandates, the Governor's budget proposes to suspend their operation in the budget year. Below, we describe the seven election-related mandates and make recommendations on whether they should be funded, suspended, or repealed. (Chapter 1124, Statutes of 2002 [AB 3000, Committee on Budget], requires the Legislative Analyst's Office to review each mandate included in the CSM's annual report of newly identified mandates. Our recommendations below regarding the two new mandates are in fulfillment of Chapter 1124's requirements.)

Election-Related Mandates. As summarized in Figure 2 (see next page), the seven election-related mandates are:

- ***Voter Registration Procedures (Chapter 704, Statutes of 1975 [AB 822, Keysor]).*** This mandate reimburses counties for the net costs associated with a number of changes made to voter registration procedures in 1975.
- ***Absentee Ballots (Chapter 77, Statutes of 1978 [AB 1699, Lehman]).*** This mandate specifies that all voters are eligible to receive an absentee ballot. Under prior law, only those voters who met certain conditions (illness, disability, absence from precinct, etc.) were eligible to vote by absentee ballot.
- ***Handicapped Voter Access Information (Chapter 494, Statutes of 1979 [AB 745, Moore]).*** This mandate requires that disabled voters have access to all polling locations. Subsequent to the mandate's passage, federal law has imposed more extensive requirements in this area. With the requirements of federal law in place, this mandate has been suspended in recent years.
- ***Permanent Absentee Ballots (Chapter 1422, Statutes of 1982 [AB 350, Agnos]).*** This mandate requires counties to allow disabled voters to request status as a permanent absentee voter, so that they do not need to apply for an absentee ballot for each election. Chapter 922, Statutes of 2001 (AB 1520, Shelley), extends this requirement to all absentee voters. In September 2003, a county filed with the CSM to begin the process of determining whether

Chapter 922 is a reimbursable state mandate. (Legislative analyses at the time of Chapter 922's passage assumed the requirements would be a state reimbursable mandate.)

Figure 2

Election Mandates Proposed for Suspension

(Dollars in Thousands)

Mandate	Estimated Annual Costs	Outstanding Liability[a]	LAO Recommendation
Voter registration procedures	$998	$3,235	Fund, but reform reimbursement methodology
Absentee ballots	13,538	31,946	Fund, but reform reimbursement methodology
Handicapped voter access information	—	—	Repeal
Permanent absent voters	1,984	4,012	Fund, but reform reimbursement methodology
Brendon Maquire Act	N/A	—	Fund
Presidential primaries	—	1,520	Repeal
Absentee ballots: tabulation by precinct	7	216	Fund
Totals	**$16,520**	**$40,929**	

[a] As of November 30, 2004.

- ***Brendon Maguire Act (Chapter 391, Statutes of 1988 [AB 2582, Duplissea]).*** This mandate specifies the election procedures when a candidate dies within three months of the general election. In those rare instances when the provisions of Chapter 391 apply, the state is responsible for reimbursing local governments for the costs of a special election.
- ***Presidential Primaries (Chapter 18, Statutes of 1999 [SB 100, Burton]).*** Chapter 18 placed new reporting requirements on county

election officials for the March 2000 statewide primary election. At that time, Proposition 198's open primary system was in effect—allowing voters from any party to vote in a party's primary. The by-laws of the major political parties, however, only allow registered party voters to determine delegates to their national conventions. In order to allow for the determination of party delegates consistent with these by-laws, Chapter 18 requires counties to report primary election results by voters' party affiliations. Since the passage of Chapter 18, Proposition 198's system was found unconstitutional by the U.S. Supreme Court. Consequently, the requirements of Chapter 18 will not mandate any reporting activities for future primary elections. The mandate's $1.5 million in costs to date are one-time in nature.

- ***Absentee Ballots—Tabulation by Precinct (Chapter 697, Statutes of 1999 [AB 1530, Longville]).*** Chapter 697 placed new reporting requirements on county election officials for the November 2000 statewide election. In order to assist the Legislature in making redistricting decisions, counties were required to report absentee voting returns by precinct. Typically, counties have been able to report absentee voting as a lump-sum total. Chapter 697 added this requirement for the November 2000 election only. In addition, under Chapter 697, counties are now required to maintain precinct information for each absentee voter on an ongoing basis. Of the $216,000 in reported costs to date, about $7,000 is estimated to be an annual ongoing expense (for counties to maintain their absentee voter precinct information).

Governor Proposes to Suspend All Election Mandates

Proposed Suspensions Would Save $16.5 Million. As noted above, the Governor proposes to suspend all seven of these election-related mandates. (The administration inadvertently failed to include the suspension of three of the mandates in the January 10 version of the budget bill but plans to propose the technical corrections to suspend them.) Based on recent claims by local governments, these suspensions would likely reduce the state's General Fund costs by $16.5 million in 2005-06. As shown in Figure 2, the accrued liabilities from past-year claims from these mandates is nearly $41 million. Under the Governor's proposal (embodied in ACA 4x [Keene]), these accrued liabilities would be paid back over 15 years.

Counties Would Have Option to Maintain Procedures. Other than the potential savings, the administration has not provided the Legislature any policy rationale for the suspension of the mandates. By suspending the mandates, the requirements under state law become optional for local governments. In the context of these mandates, that means, for instance, that each county could decide whether to offer absentee ballots to voters who did not meet the pre-1978 criteria of being disabled or ill. Without a stated policy rationale, it is unknown whether the administration, through the suspensions, hopes to encourage election-related changes—such as a move away from uniform state laws to a more county-based system or a reduction in the use of absentee ballots.

Recommend Two Mandates for Repeal

We recommend that the Legislature repeal the handicapped voter access information and presidential primaries mandates. Repealing both mandates would not affect election procedures.

As noted above, federal law now generally provides greater protections and rights for disabled voters than that of the handicapped voter access information mandate. For this reason, the mandate has been long suspended. We therefore can find no policy reason why it is necessary to maintain the mandate's provisions in state law. Likewise, since Proposition 198 is no longer in effect, the provisions of the presidential primaries mandate no longer place any meaningful requirements on counties. Consequently, we recommend that the Legislature repeal both of these mandates.

Fund Two Mandates With Minimal State Costs

We recommend that the Legislature fully fund the Brendon Maguire Act and the absentee ballot—tabulation by precinct mandates. Absent changes in state law, the mandates can be implemented at minimal expense. (Increase Item 0890-295-0001 by $8,000 and make conforming changes in Provision 1.)

In most years, since candidate deaths immediately prior to elections are rare, the provisions of the Brendon Maguire Act would not be triggered and the state would not incur any costs. If the Legislature wishes to change its policy regarding the death of candidates, providing a new statutory framework would be more appropriate than a year-to-year suspension of the mandate. Regarding the tabulation of absentee ballots, almost all of the mandate's costs were one-time in nature. Funding the continuation of the mandate would incur only minimal additional costs since counties are simply maintaining existing lists. Suspending the mandate and then reinstating it in future years, however, could be relatively much more expensive—since counties again could incur substantial one-time costs if they chose to abandon their lists during the suspension. Fully funding these two mandates would be consistent with prior legislative policy. We therefore recommend that the Legislature fund the mandates. This recommendation would require a total appropriation of $8,000—$1,000 for the Brendon Maguire Act (since no costs are expected) and $7,000 for the tabulation mandate.

Reform Three Mandates

In order to maintain statewide uniformity in election procedures, we recommend rejecting the Governor's proposal to suspend three mandates. Instead, we recommend funding the mandates under a new reimbursement methodology. The State Controller should convene a working group to develop a simpler reimbursement system.

The remaining three mandates—voter registration procedures, absentee ballots, and permanent absentee ballots—are the state's most expensive elections-related mandates.

Statewide Uniformity Valuable. The administration's proposal would allow county-by-county variation in many aspects of administering elections. California's election system is structured to allow some variation—such as by allowing the use of different voting machines across the state. We believe, however, that the basic procedures in administering elections should be uniform. Changes in administrative procedures—such as who is eligible for an absentee ballot—could significantly affect voter turnout across counties.

Suspensions Could Cause Confusion Regarding Election Procedures. Moreover, because these mandates are intertwined with many basic procedures of the state's election process, suspending them would be more complicated than for a typical mandate. Under the administration's proposal, voters and counties would be left with a confusing array of laws with no clear indication as to what is required under state law. For instance, Chapter 704 implemented a broad range of registration procedural changes—some of which increased costs and others lowered costs. How could counties determine which procedures are assumed to increase costs and, therefore, are optional?

Recommend Rejecting Suspension. In order to maintain a basic level of uniformity and avoid confusion over election procedures, we recommend that the Legislature reject the administration's proposal to suspend the mandates. Instead, we recommend that the Legislature fully fund these mandates. As discussed below, however, we believe the methodology to provide counties with reimbursements needs to be reformed.

Problems Identified With Claims. We recently reviewed a sample of recent local government claims for the absentee ballot mandate. Our review found:

- ***Wide Variation in Costs.*** On a per-ballot basis, claims reflected a tremendous variation in the amount sought for reimbursement. Some jurisdictions' claimed costs per ballot were 30 times more expensive than other jurisdictions. For 2002-03, for example, the claims varied from a low of 65 cents to a high of $21.91 per absentee ballot.

- ***High Overhead Charges.*** Local governments are eligible to claim overhead charges on salary and benefit expenses. Governments are able to claim a 10 percent overhead automatically but can submit claims for higher amounts with appropriate documentation. Our review found extremely high levels of requested overhead charges—with many jurisdictions claiming overhead rates well over 100 percent and one exceeding 197 percent. We are not aware of any factors that would justify such high charges.

- ***Some Costs Appear Disallowable.*** Our review also indicates that some jurisdictions appear to be claiming costs that are not allowable under the mandate. For instance, a number of jurisdictions cited expenses related to permanent absentee ballots. A portion of these costs may be claimable under the separate permanent absentee ballot mandate for disabled voters. We were not able to determine if jurisdictions are simply misfiling the claims or double billing for certain expenses. However, the remainder of these costs are likely related to nondisabled voters. Since Chapter 922 (the law allowing nondisabled voters to obtain permanent absentee ballot status) has not yet been determined to be a reimbursable state mandate, these costs should have been excluded from claims.

Need New Process. The current mandate reimbursement process for these three mandates involves extensive paperwork and filings—even when minimal amounts are sought in reimbursements. In addition, the interaction of various state requirements makes it difficult to properly claim the appropriate amounts of reimbursements. Consequently, we believe that the state should develop a simpler and more straight-forward approach to providing local governments with a reasonable allocation of funds to perform their state-mandated election duties.

Recommend Working Group to Determine Reasonable Reimbursement Methodology. To develop a reasonable payment methodology, we recommend that the State Controller's Office convene a working group. Such a group should include staff from the SOS, DOF, CSM, county election officials, and the Legislature. The group should develop a simpler methodology that accounts for the interaction of all three mandates. Such a methodology could develop a reimbursement per voter to eliminate the need for extensive paperwork. (Such an approach was used to develop the original reimbursement method for the voter registration mandate.) Finally, the group should provide an estimate of the necessary amount to fund these costs. Under the existing process, the mandates would cost the state $16.5 million in 2005-06. With a more straight forward reimbursement methodology that reduces the problems with existing claims, we would expect the cost to be considerably less. The group should present a revised methodology to the Legislature in the spring—in time to be included in legislation as part of the budget package in place of the existing reimbursement methodology.

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 state-owned parcel just south of the central part of Los Angeles. The CSC's budget includes the costs of operating Exposition Park, the California African American Museum, the Science Center museum, and the Science Center school. The budget proposes to continue current expenditure levels of $19.9 million for 174 positions in 2005-06 for the department, including $14.5 million from the General Fund, $3.8 million from the Exposition Park Improvement Fund, and $1.6 million in reimbursements.

Information on Admission Fee Not Provided

We withhold recommendation on the department's proposed General Fund budget pending receipt and review of the department's report on options for charging an admission fee. The report was not provided to the Legislature by January 15, 2005, as required.

Background. The Science Center museum, 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 a total of $11.3 million in General Fund spending for the museum—$8.6 million for operational costs and $2.7 million for payment of lease revenue bonds for the facility. The Science Center is the only museum to receive state General Fund dollars of this magnitude on an ongoing basis.

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 $7 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.

Admission Fee Information Required. In the *Analysis of the 2004-05 Budget Bill*, we recommended phasing out the Science Center's General Fund budget in place of private donations, admission fees, and other nonstate revenues (please see page F-60 to page F-61). In order for the Legislature to acquire more information regarding admission fees, the 2004-05 budget requires the CSC to provide information by January 15, 2005 detailing options for charging an admission fee to the museum. At the time this analysis was prepared, the department had not submitted the report to the Legislature.

Withhold Recommendation Pending Receipt and Review of Report. Since the Legislature has not received the report, we withhold recommendation on the department's General Fund budget pending receipt and review of the required information.

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) programs. The FTB also administers the Homeowners' and Renters' Assistance Programs, 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 $700 million ($512 million General Fund) and 5,285 positions in support of FTB's operations. Compared to the current-year budget, this represents an increase of $81 million (13 percent) and a General Fund increase of $26 million.

The increase in funding is due almost entirely to increased 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 total increase in support for CCSAS is $79 million, comprising $53 million of other funds and $26 million General Fund. Elsewhere in this analysis, we discuss the past performance and current status of CCSAS and related child support collection activities (see "Health and Social Services" chapter).

In addition to the increase in support for CCSAS, there is an increase in General Fund support for two components of FTB's tax program activities. The ongoing activities associated with abusive tax shelters is slated to receive an additional $1.8 million and a new "tax gap" enforcement program has been proposed at a cost of $8.6 million. These increases are partially offset by decreases due to one-time cost reductions, expiring programs, and unallocated reductions in state operations.

Electronic Technologies Cut Costs

We recommend that the Legislature reduce the Franchise Tax Board's budget by $800,000 to account for cost savings in 2004-05 and 2005-06 associated with the migration of tax return and remittance submissions from paper versions to electronic data. (Reduce Item 1730-001-0001 by $800,000.)

In our January 2005 report, *Tax Agency Consolidation: Remittance and Return Processing*, we noted that some of the state's tax agencies have made considerable strides in electronic remittance and return processing, including FTB. The costs associated with processing electronically filed returns and remittances is a fraction of the costs associated with paper documentation. For example, the FTB reports that about 4,800 *electronic* remittances are processed per each direct staff hour. By comparison, only 62 *paper* remittances are processed per direct staff hour. This cost differential translates directly into budget savings.

Information provided by FTB indicates substantial growth in electronic filing of returns and remittances. This growth has occurred as a combined result of statutory mandates for tax practitioners as well as a "natural" migration from paper to electronic filing by individual and business taxpayers. The FTB reports that between the 2000 tax year and the 2003 tax year, electronically filed returns expanded from 2.3 million to 3.7 million, or 63 percent. Similarly, electronically filed remittances grew from 0.8 million to 1.2 million, or 47 percent. The department expects 10 percent annual growth in electronic remittances through 2008, and 5 percent to 10 percent annual growth in electronic returns through the same period.

Reflecting the growth in electronic filings and remittances—and the large cost savings associated with the use of this technology—the department's budget was reduced in stepwise fashion beginning in 2001-02 and continuing through 2003-04. These reductions ranged from $400,000 to about $1 million. The largest reduction was proposed in the context of requiring mandatory e-filing by tax practioners filing in excess of a specified number of tax returns.

No such budget reductions were proposed as part of the 2004-05 budget or the 2005-06 budget. Given the continued growth in e-filing and the cost savings associated with not printing, mailing, or processing paper returns, FTB has experienced cost savings associated with this shift in filing methods. Based on the lower end of the savings achieved in prior years, we recommend that the Legislature reduce the FTB budget by

$800,000, reflecting savings achieved in 2004-05 and 2005-06 through the development and deployment of electronic technologies.

Tax Gap Expenditures Could Be Reduced

We recommend that the Legislature reduce budget authority by $200,000 to account for cost savings associated with hiring auditors at the entry-level salary instead of the midrange given the straightforward nature of the audits such individuals will be conducting. (Reduce Item 1730-001-0001 by $200,000.)

The administration's proposal to fund a tax gap project for FTB includes a sizeable cost component for the hiring of auditors. The proposal calls for the hiring of 36 associate tax auditors at a monthly salary of $4,782, or at the midrange of the salary schedule.

To a large extent, FTB's most experienced auditors have been shifted over to the abusive tax shelter project, where very complex auditing and financial activities are conducted. The audits that are likely to be associated with tax gap activities, by contrast, are likely to be rather straightforward and not require a substantial amount of previous experience. While in past years hiring auditors at the entry-level salary may have been difficult, we think the current hiring situation allows for budgeting these positions at the entry level. As a result of the improved hiring climate, the agency should be able to attract sufficient applicants at the entry-level salary.

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 $970 million from various funds to support DGS activities in 2005-06.

Budget Provisions Need Clarification

The budget includes provisions that authorize the Departments of General Services (DGS) or Finance to increase spending authority for several DGS revolving funds during the year in order to provide services or purchase equipment for departments. Contrary to the intent of the provisions, the current administration has used these provisions to accommodate workload growth increases which should have been anticipated. For this reason, we recommend that the Legislature clarify DGS' provisional authority to authorize increases for only unanticipated expenses.

Since 1987, the budget has included provisions that allow midyear increases to the DGS Service Revolving Fund (SRF) and other DGS revolving funds in order to meet customer requests. Specifically, provisions 3 and 4 of Item 1760-001-0666 allow DGS (up to 10 percent of the revolving funds) or the Department of Finance (over 10 percent of the revolving funds) to increase the expenditure authority when (1) the Legislature has approved funds for departments to purchase equipment or services from DGS or (2) a local government agency or the federal government has requested DGS services. For increases proposed to be permanent, the administration also is required to submit the request through the annual budget process the following year.

Budget Provisions Allow DGS to Accommodate Department Requests. Because DGS is a provider of services to other departments, there are occasions when DGS needs to increase its expenditure authority to accommodate unanticipated department requests. For example, there may be instances when the Legislature has provided funds in other departments' budgets for DGS services without prior DGS knowledge. In addition, there may be occasions when costs for some DGS purchases are higher than what was expected when the budget was developed. Since the Legislature has already approved these services or purchases under prior legislative actions, additional "upfront" notification to the Legislature is not necessary, and DGS is able to provide services without disruption. Provision 6 requires that DGS notify the Legislature within 30 days after increases are made.

Recent Increases Have Been for Anticipated Workload Growth. Since July 2004, DGS has increased the SRF current-year expenditure authority five times, totaling $9.2 million and 17 positions. With the exception of a $404,000 equipment purchase, these increases were due to ongoing workload growth in the Office of Administrative Hearings, Office of Fleet Administration, and the Real Estate Services Division. Most of the workload growth had occurred in these DGS areas over the past few years and, therefore, should have been anticipated.

Anticipated Workload Growth Should Be Reviewed During Annual Budget Process. Departments should examine their workload on an annual basis. If workload has increased, then the department should request additional resources through the annual budget process. This process provides the Legislature with the opportunity to review the proposal and then make decisions on the proposal *before* the department has actually hired staff and increased expenses. Under prior administrations, this was the practice, and DGS submitted workload growth requests through the annual budget process. Under the current administration, however, DGS has interpreted the budget provisions to allow anticipated workload growth increases. This interpretation unnecessarily limits the oversight role of the Legislature.

Clarify Provisional Authority for Unanticipated Expenses. It is important for DGS to be able to accommodate unanticipated department requests without delaying purchases or disrupting services. We also believe, however, that requests for anticipated workload should be provided during the annual budget process. In our view, DGS should follow the same process for anticipated workload growth increases as other departments. For this reason, we recommend that the Legislature clarify DGS' provisional authority to only authorize increases for unanticipated expenses.

DGS Can Improve Its Drug Procurements

In "Part V" of* The 2005-06 Budget: Perspectives and Issues*, we review the state's procurement and administrative operations for drug purchases. In that review, we found a number of deficiencies in activities performed by the Department of General Services (DGS). To correct these deficiencies, we recommend that the Legislature take of a number of actions that would result in lower state drug prices. For this reason, we recommend that the Legislature direct DGS to submit a budget proposal to implement recommendations from our review.

In Part V of *The 2005-06 Budget: Perspectives and Issues*, we examine how the state purchases drugs for its program recipients. We found several deficiencies in how DGS procures drugs for five state agencies. Specifically, we found that DGS (1) does not use an annual work plan, (2) purchases about one-half of its drugs without contracts, (3) does not participate in groups that perform drug reviews, and (4) does not collaborate and share information with other state agencies that also purchase drugs. To address these deficiencies, we recommend that the Legislature:

- Increase DGS staff in order to create more drug contracts which would result in lower drug prices.
- Require DGS to develop an annual work plan that would provide a comprehensive approach to its drug procurement activities.
- Require DGS to participate in drug review groups in order to generate long-term savings and improve the quality of health care.
- Direct DGS and the California Department of Corrections to compare potential methods to lower parolee drug costs.
- Direct DGS and the University of California to identify joint drug purchase opportunities in order to lower drug costs for both agencies.

Direct DGS to Submit Proposal to Implement Recommendations. To correct the DGS deficiencies found in our review, we recommend that the Legislature direct DGS to provide a budget proposal in the spring that provides a plan and the costs to implement the recommendations noted above.

STATE PERSONNEL BOARD
(1880)

The State Personnel Board (SPB) has the authority under the State Constitution and various statutes to adopt civil service rules and regulations. An executive officer appointed by the board is responsible for administering the merit aspects of the state civil service system. (The Department of Personnel Administration administers the nonmerit aspects of the state's personnel systems.) These duties include, but are not limited to, adopting classifications within the State Civil Service System, conducting hearings and appeals on matters of discipline for civil service employees, and developing and administering the merit-based civil service hiring and promotional process.

The board and its staff are also responsible for establishing and administering, on a reimbursement basis, merit systems for certain city, county, and civil defense employees, to ensure compliance with federal requirements. In addition, SPB is responsible for coordinating equal employment opportunity efforts within state and local government agencies, in accordance with state policy and federal law.

The budget proposes $19 million for SPB support in 2005-06, which is $88,000, or 0.5 percent, more than estimated current-year expenditures. The proposed expenditures consist of $3.9 million from the General Fund and $15 million in reimbursements from state departments and other government entities.

POBOR MANDATE

We recommend the Legislature request the Commission on State Mandates to reconsider its decision regarding the Peace Officer Procedural Bill of Rights mandate in light of a recent California Supreme Court decision.

Background

Seeking to ensure stable employer-employee relations and effective law enforcement services, the Legislature enacted the Peace Officer Procedural Bill of Rights (POBOR), Chapter 465, Statutes of 1976 (AB 301, Keysor). This measure provides a series of rights and procedural protections to peace officers who are subject to interrogation or discipline by their employer.

In 1995, the City of Sacramento filed a claim with the Commission on State Mandates, alleging that POBOR (including nine subsequent legislative measures that clarified or expanded POBOR) constituted a reimbursable state-mandated program within the meaning of Article XIII B, Section 6 of the California Constitution. In 1999, the commission adopted its "Statement of Decision," finding to be a mandate those procedural requirements of POBOR that exceed the rights provided all public employees under the Due Process Clause of the United States and California Constitutions. For example, the commission found to be a mandate the POBOR requirement that peace officers are entitled to administrative hearings if an employer decides to transfer a peace officer as punishment.

In its 2005-06 proposed budget, the administration defers funding for the annual costs of POBOR (about $30 million), noting that Proposition 1A (approved by the voters in November 2004) exempts mandates pertaining to labor relations from its annual funding requirement. The administration also proposes to fund the backlog of unpaid local government POBOR claims (totaling about $250 million) over a period of 15 years.

Recent Court Decision Casts Doubt On Commission's Mandate Determination

In a 2004 ruling, the California Supreme Court substantially changed prior legal thought regarding state laws that impose procedural requirements on local agencies. In *San Diego Unified School District versus Commission on State Mandates,* the Court found that state procedural requirements do not constitute a reimbursable mandate if local agencies have a choice whether to implement the program (or take the action) triggering the state requirements. Specifically, the Court considered school district costs to comply with state procedural requirements when electing to expel a pupil. The Court found that *" . . . no hearing costs incurred in carrying out those expulsions that are discretionary under Education Code section 48915—including costs related to hearing procedures claimed to exceed the requirements of federal law—are reimbursable."*

The California Supreme Court's ruling in the *San Diego Unified* case suggests that the commission's approach in reaching its decision regarding POBOR is no longer valid. Specifically, in reaching its POBOR decision, the commission determined that certain state procedural requirements exceeded the requirements of federal law and the State Constitution. The commission did not consider whether any state laws *require* local agencies to take the actions triggering the POBOR requirements.

Given the legal questions posed by the *San Diego Unified* case, we recommend the Legislature request the commission to reconsider its POBOR decision. (It is important to note that any change to the commission's POBOR mandate ruling would *not* affect peace officer procedural rights in any way.) In addition, given the large number of POBOR mandate claims awaiting payment at the State Controller's Office, we recommend the Legislature specify the time period for which any modified mandate determination would apply. In general, the Legislature has wide authority to apply a revised mandate determination retroactively or prospectively. Given that the state did not challenge the commission's Statement of Decision for this mandate at the time of its adoption, however, local agencies have been operating under the assumption that the state would provide reimbursement for POBOR costs as defined by the commission. Accordingly, we believe a *prospective* application of any revised POBOR mandate determination would be appropriate.

The following budget language would (1) give the commission the authority and responsibility to complete such a review and (2) maintain the state's responsibility for reimbursing local agencies' costs until any modifications to the mandate determination were adopted:

> In 2005-06, the Commission on State Mandates shall review its Statement of Decision regarding the Peace Officer Procedural Bill of Rights (POBOR) test claim and make any modifications necessary to this decision to clarify whether the subject legislation imposed a mandate consistent with the California Supreme Court 2004 decision in *San Diego Unified School District versus Commission on State Mandates* and other applicable court decisions. If the commission revises its Statement of Decision regarding the POBOR mandate, the revised decision shall apply to local government POBOR activities occurring after the date the revised decision is adopted.

STATE TEACHERS' RETIREMENT SYSTEM (1920)

The Governor's budget proposes shifting the state's contribution for basic teacher retirement to schools. (This includes K-12 school districts, county offices of education, and community colleges.) The budget assumes $469 million in General Fund savings from this reduction in state contributions to the State Teachers' Retirement System (STRS).

In this piece, we:

- Describe the retirement plan for teachers, its funding, and its unfunded liability.
- Lay out criteria for increasing local control, flexibility, and responsibility for a teacher retirement system.
- Describe and evaluate the Governor's proposal to shift contributions to school districts in the context of these goals.

BACKGROUND

The Basics of the STRS Plan

Defined Benefit Pays 2 Percent at 60. All K-12 and community college teachers in public schools who work at least half-time are required to participate in the state-sponsored retirement plan administered by STRS. This is a "defined benefit" program, which guarantees a certain lifetime monthly pension benefit based on salary, age, and years of service at retirement. The basic defined benefit pension for retired teachers pays 2 percent of salary for each year of service at age 60.

Recent Benefit Enhancements. Beginning in the late 1990s, when STRS investment returns had resulted in full plan funding, the state approved a series of benefit enhancements. Effective in 1999, the state approved higher percent-of-salary formulas to calculate pension benefits for teachers who are above 60 years of age and/or have 30 years of service.

Effective in 2001, the state again enhanced benefits as investments continued to surge. These changes instituted the following:

- Highest one-year salary (rather than the standard three-year period) to calculate pensions for teachers with 25 or more years of service.
- Additional dollar amounts per month for teachers who retire by the end of 2010 with 30 or more years of service.
- Diversion of 25 percent of teacher contributions—2 percent of the total 8 percent—to a new defined benefit supplement (DBS) program. This program includes individual accounts designed to provide extra retirement income above the defined benefit pension. This diversion is in effect through 2010.
- STRS payment of Medicare Part A (hospitalization insurance) premiums for retiring teachers who did not pay Medicare taxes (hired before April 1986) and must, therefore, pay the full Part A premium to participate in the federal program.

In addition, the state also approved:

- Allowing retirement credit for accumulated sick leave.
- Increasing the inflation protection benefit from 75 percent up to 80 percent. This benefit increases retirees' pensions when inflation erodes their initial allowances to below 80 percent of their original purchasing power.

Three Contribution Sources Finance Benefits. Contributions to STRS are fixed in statute. Teachers contribute 8 percent of salary to STRS, while school districts contribute 8.25 percent. Figure 1 compares employee and employer contribution rates for STRS and related or comparable Public Employees' Retirement System (PERS) plans.

In addition to the teacher and school contributions, the state contributes 4.517 percent of teacher payroll to STRS (calculated on payroll data from two fiscal years ago). The state contribution includes:

- 2.017 percent for the enhanced defined benefit program. This payment would be $469 million in 2005-06, if not for the Governor's proposal to shift the payment to school districts.
- 2.5 percent to finance purchasing power protection at 80 percent. This payment will contribute $581 million in 2005-06.

Unlike typical defined benefit programs such as those administered by PERS, neither the STRS employer nor the state contribution rate varies annually to make up funding shortfalls or assess credits for actuarial surpluses.

Figure 1

STRS Retirement Contributions Less Than Average PERS Contributions

	STRS	PERS Miscellaneous Tier 1	PERS School Employees
Employees			
Pension	8.0%	5.0%[a]	7.0%
Social Security	—	6.2	6.2
Totals	**8.0%**	**11.2%**	**13.2%**
Employers			
Pension	8.25%	12.4%[b]	7.6%[b]
Social Security	—	6.2	6.2
Totals	**8.25%**	**18.6%**	**13.8%**

a On amount of monthly salary in excess of $513.

b Varies annually for State Miscellaneous Tier 1 and noncertificated school employees. Amount shown is the 25-year average contribution rate.

Surcharge Triggered for First Time. The state also pays a surcharge when the teacher and school district contributions noted above are not sufficient to fully fund the pre-enhancement benefits within a 30-year period. Because of the downturn in the stock market, an actuarial valuation as of June 30, 2003 showed a $118 million shortfall in these baseline benefits—one-tenth of 1 percent of accrued liability. Consequently, this surcharge kicked in for the first time in the current year at 0.524 percent for three quarterly payments. This amounts to an additional $92 million from the General Fund in 2004-05.

The Governor's budget assumes this surcharge is discontinued in 2005-06 based on greater-than-assumed investment returns for 2003-04. It will not be known, however, whether the surcharge will continue until a new valuation becomes available in the spring. If it does continue, the 2005-06 General Fund cost for a full year would be between an estimated $120 million and $170 million.

Actuarial Valuation Finds Funding Shortfall

In addition to the small shortfall in pre-enhancement benefits (triggering the current-year surcharge), the recent valuation also showed a substantial $23 billion unfunded liability for the entire system, including enhanced benefits. That is, existing contributions from teachers, school districts, and the state are not sufficient to fully fund retirement benefits. As a result, STRS has just 82 percent of the assets necessary to pay accrued benefits.

As noted above, the pre-enhancement benefit structure has just a fractional shortfall. Consequently, the large systemwide unfunded liability results from the recent benefit enhancements. As described in the nearby box, STRS is currently reviewing options to address this shortfall.

Local Program Has No Local Control Or Responsibility

System Problems

We believe there are three main problems with the current method of providing teacher retirement benefits.

Larger State Teachers' Retirement System (STRS) Funding Issue Looms

Shortfall Amounts to an Extra $1 Billion in Annual Contributions. The Governor's cost-shift proposal comes at a time when STRS faces another significant funding issue—the $23 billion unfunded liability noted in the main text. The STRS estimates that the retirement fund needs the equivalent of an additional 4.438 percent of salary over a 30-year period to retire the unfunded liability. This amounts to additional contributions exceeding $1 billion annually.

Options for Closing the Gap. The STRS has developed a dozen options for the board to consider to address the identified shortfall. Most of these options would require legislative action. The options can be grouped into three categories:

- ***Rescinding Recent Benefit Increases.*** The majority of the options would roll back benefits provided to teachers in recent years. In most cases, these changes could only be implemented for teachers who begin working after the new changes take effect. (Courts have considered pension plans to be part of the employment contract. Once a teacher begins working, therefore, the pension is not changeable without some offsetting benefit.)

Passive State Role in Teacher Compensation, Except for Retirement. As described above, the state is extensively involved in providing teacher retirement benefits and designating funding for this local program. This active role is contrary to the state's passive role in other forms of teacher compensation. The most significant form of compensation—teacher salaries—is left to local school districts and their employees to determine through collective bargaining. Moreover, because the state contributes to the retirement system, local districts do not bear the full costs of retirement plans, unlike teacher salaries.

No Plan Flexibility. In addition, the state-run system limits the choices of both school districts and teachers. With a single benefit structure and required contributions spelled out in statute, districts and teachers have no choices about how best to meet their pension needs. For example, some districts might prefer to use retirement contributions to finance other pension plans that better meet their overall funding needs. Similarly, teacher retirement needs may vary dramatically. Some teachers may prefer to weight their compensation toward present needs. Other teachers may want to forego

- ***Additional Contributions.*** The state could increase contributions for teachers, school districts, and/or the state to cover the liability. As with reductions in benefits, the state generally would not be able to increase current teachers' contribution rates.
- ***Refinancing the Unfunded Liability.*** The STRS typically amortizes unfunded liabilities over a 30-year period. One refinancing option developed by STRS would stretch these payments over 40 years. (This time period would exceed the bounds of what is allowed for private pensions and is outside the norm for the state's practice.) Another option would be the issuance of a pension obligation bond. By issuing a bond at a lower interest rate than STRS' assumed rate of return (currently 8 percent), the state could reduce its interest payments over time. The Legislature would have to determine who is responsible for providing the resources to pay off the bond.

STRS Board Will Weigh Options This Spring. The STRS board has asked constituent groups for their comments, preferences, and recommendations on these options. The board has also requested an updated actuarial valuation as of June 30, 2004, which will be available in the spring. After this process, the board plans to bring proposals to the Legislature to address the unfunded liability.

some current salary for an even more generous retirement allowance than that provided through the STRS program.

State Viewed as Funder of Last Resort. As noted above, all contributing parties—teachers, school districts, and the state—have fixed contributions in statute. Thus, there is no designated responsibility for long-term funding shortfalls, such as the current $23 billion gap. In fact, because the state requires school district participation and designates the rates paid by teachers and school districts, the Legislature may feel compelled to pick up some or all of the unfunded liability despite the local nature of the program. In this way, the current system prevents funding decisions from being viewed as a local responsibility.

Long-Term Solutions

In our view, the long-term solution to these issues is to put decision making and responsibility for school retirement (including nonteaching or noncertificated employees) at the local level with employers (school districts) and employees (teachers). In other words, treat teacher retirement the same as other local government retirement programs. This would include:

- Having all costs borne by school districts and/or teachers, rather than the state being responsible for some share of costs.
- Allowing local flexibility for schools to choose different retirement plans—for teachers and noncertificated staff—that best meet local needs. This could be through STRS, PERS, or other venues such as joint powers authorities.
- Assuring fiscal soundness in that all potential costs are designated to be covered by employers and employees without the necessity of future statutory changes.

It is these criteria that we use to evaluate the long-term impact of the Governor's proposal for teacher retirement. In addition, there are short-term issues the proposal raises as a 2005-06 budget balancing solution.

Governor Proposes Cost Shift to School Districts

Proposal

The budget proposes shifting the state's benefits contribution to school districts. (The state would continue annually paying 2.5 percent of payroll to the inflation protection account.) The proposal would increase districts' contributions by 2 percent of payroll, resulting in a total district payment of 10.25 percent. (The state's contribution of 2.017 percent of payroll from two years ago is equivalent to a district payment of 2 percent at current payroll.) This amounts to roughly $500 million in additional contributions. The Governor's proposal would allow school districts to pass through to employees this additional contribution through collective bargaining. Consequently, teachers could contribute as much as 10 percent of their wages toward retirement.

To maintain take-home pay, however, teachers would also have the option of ending the equivalent diversion—2 percent—of the employee contribution to DBS (described previously). This component of the Governor's proposal is not contingent on school districts passing through the shifted responsibility for the 2 percent benefits contribution. Teachers could elect to stop contributing to DBS and receive that compensation in take-home pay regardless of whether districts or teachers pay the benefits contribution.

The administration proposal to shift the state's benefits contribution to school districts also includes eliminating the statutory provision for the surcharge when there is an unfunded liability in the pre-enhancement benefits.

Administration Asserts State Commitment Fulfilled. The administration asserts that the state fulfilled its 1971 promise—included in Chapter 1305, Statutes of 1971 (AB 543, Barnes)—to contribute a fixed dollar amount to the system for 30 years. This period would have ended in 2001-02, four years after the STRS program reached 100 percent funding.

Short Term: Does the Governor's Proposal Work As a 2005-06 Budget Solution?

We find that the Governor's proposal to shift the state benefits contribution to school districts likely would not achieve the intended savings under current law.

The Governor's proposed budget solution assumes the shift of STRS costs would provide ongoing General Fund relief. As we discuss below, however, these savings may not be achievable.

Shift Could Require Proposition 98 "Rebenching." Retirement contributions for school teachers and administrators are an operating cost schools face, like salaries and other benefits. When the state was implementing Proposition 98, however, it decided which programs to include within the minimum guarantee. At that time, the state decided to keep its STRS contributions outside of the guarantee. While the state can move a funding responsibility from outside of Proposition 98 into the guarantee, state law requires that the minimum guarantee be rebenched to reflect this added responsibility. Thus, the Governor's proposal would likely require a $469 million upward rebenching of the minimum guarantee. If so, the proposal would not result in any General Fund savings.

Long Term: Does the Proposal Move Toward the Goals of Local Control and Responsibility?

The Governor's proposal would not fundamentally reform the State Teachers' Retirement System. To move towards a retirement system that emphasizes local control and responsibility, the Legislature would need to focus on a new approach for new teachers.

Shortcomings in System Would Remain. On a long-term basis, the Governor's proposal would not bring the state significantly closer to a teachers' retirement system which reflects local control and responsibility.

- ***Local Control.*** The Governor's proposal would shift the costs of a local program to the local level. Yet, the proposal would not fundamentally change the state's role with regard to STRS. First, the state would continue to have an active role in the costs of the program—by contributing to the purchasing protection program. Second, the state would remain actively involved in determining future benefit changes.
- ***Local Flexibility.*** The Governor's proposal also would not increase flexibility for school districts or teachers. Every school district would continue to offer the same retirement plan for teachers, regardless of local circumstances.
- ***Designated Funding Responsibility.*** Finally, the proposal would not designate which entity would be responsible for any financial shortfalls. Consequently, the state could continue to be viewed as the funder of last resort, reducing local responsibility for the program.

Limitations on Changing System for Existing Teachers. For these reasons, the Governor's proposed cost shift would not fundamentally reform the existing STRS system. For existing teachers, the Legislature may find it difficult to reach the long-term goals of local control, flexibility, and designated funding responsibility with any proposal. Once in place, retirement systems are difficult to alter. By viewing a retirement program as part of the employer-employee contract, the courts have placed significant limits on the types of changes that can be made to a current employee's retirement program. Additionally, the state will be required to designate a source of funding to pay off the current STRS unfunded liability.

Proposals Regarding New Teachers. For new teachers, however, the Legislature would have significantly more flexibility in designing a system that focused on local control and responsibility. The Governor, for example, has proposed requiring all new state, local government, and school employees in California to participate in defined contribution retirement plans. We discuss his proposal in detail—as well as alternatives—in "Part V" of *The 2005-06 Budget: Perspectives and Issues*.

DEPARTMENT OF TECHNOLOGY SERVICES (1955)

The budget proposes the creation of the Department of Technology Services (DTS) to be the state's general-purpose information technology (IT) department. The DTS would consolidate the state's two largest data centers—Stephen P. Teale Data Center (TDC) and the Health and Human Services Agency Data Center (HHSDC)—and a portion of the Department of General Services' (DGS) Telecommunications Division (TD). The HHSDC management of several large IT projects is being proposed to be transferred to the Health and Human Services Agency (please see the "Health and Social Services" Chapter for a discussion of this proposal). Under the proposal, DTS would provide IT and telecommunication services to most state agencies and various local jurisdictions. The DTS would reside within the State and Consumer Services Agency and its operational costs would be fully reimbursed by its client agencies. The administration proposes $235 million in expenditures from a new DTS Revolving Fund. We discuss the proposed department and other issues below.

CREATION OF NEW DEPARTMENT

The proposed consolidation would likely improve the state's technology services and reduce costs to departments. For these reasons and consistent with prior legislative direction, we recommend that the Legislature approve the consolidation. We, however, raise a number of significant issues related to the administration's proposed implementation. To improve oversight, we recommend that the Legislature (1) amend the budget bill to include a revolving fund appropriation for the Department of Technology Services (DTS) consistent with current practice for data centers, (2) revise the responsibilities of the proposed Technology Services Board, and (3) allow the Governor to appoint the DTS director subject to Senate confirmation.

Background

Over the last two years, a number of steps have been taken by the Legislature and administration to consolidate the state's data centers. We discuss these steps below.

Legislature Directs Administration to Begin Consolidation Process. 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 detailed discussion of the benefits of this approach. For instance, a consolidated data center would result in increased efficiencies in supporting existing computer systems and reduce some hardware and software costs.) As required by Chapter 225, Statutes of 2003 (AB 1752, Oropeza), in May 2004 the Department of Finance (DOF) provided a conceptual plan to the Legislature for a consolidated data center. Specifically, the plan identified the goals, organizational structure, and areas of potential savings that a consolidated data center would provide to the state. The plan also identified a number of additional steps that the state would need to take—such as the creation of a consolidation planning team—to successfully complete the consolidation effort.

2004-05 Budget Act *Assumes Data Center Consolidation*. The state budget for 2004-05 assumes that data center consolidation will occur during the current year. In addition, the *2004-05 Budget Act* requires DOF to transfer $3.5 million from the TDC Revolving Fund to the General Fund to reflect savings from the data center consolidation.

Governor Requires Plan on Data Center Consolidation. In September 2004, the Governor issued an executive order directing TDC's Director to prepare a plan to reorganize and consolidate the state's two data centers. In January 2005, the plan was submitted to the Governor. The plan provides a general overview of the proposed DTS, its goals and functions, and a proposed governance structure. According to the plan and the newly proposed budget, it is now the intent of the administration to consolidate the data centers in 2005-06. The *Governor's Budget Summary* also states that the administration will prepare a Governor's reorganization plan to create DTS. It is unknown when that reorganization plan will be presented to the Legislature.

Administration's DTS Proposal

As proposed in DOF's 2004 conceptual plan, TDC and HHSDC staff have been working over the past year on various planning teams to implement the consolidated data center. According to the January 2005 data center consolidation plan and the budget, the DTS reorganization proposal will contain three major components (discussed below). Since a formal reorganization plan had yet to be submitted to the Legislature at the time this analysis was prepared, many details regarding the consolidation are still lacking.

DTS Services. By consolidating TDC, HHSDC, and a portion of DGS, DTS will provide five major services to departments:

- Install and maintain small, medium, and large computer hardware and software systems.
- Implement and maintain the state's telecommunications network and services.
- Implement information security practices to prevent computer hacking and protect the state's information systems.
- Assist departments in defining their technology needs.
- Develop state-level computer systems.

Technology Services Board (TSB). The DTS would be governed by the TSB, which would include the state Chief Information Officer (CIO), DOF's Director, State Controller, and the Governor's cabinet secretaries. The TSB would be responsible for (1) reviewing and approving the DTS' annual budget and rates, (2) appointing the director, (3) setting salaries of the director and five executive officers, and (4) approving the department's plan of operations. In addition, TSB would be required to hire an independent auditor to conduct an annual DTS financial audit.

Continuously Appropriated DTS Revolving Fund. The administration proposes to establish a continuously appropriated revolving fund that the department would use to pay its expenses. The fund would be established from the unexpended balances of the TDC and HHSDC Revolving Funds and a portion of the DGS Service Revolving Fund. Continuously appropriated funds are considered"off budget"—meaning that an appropriation for the fund does not appear in the budget bill and the Legislature does not annually review appropriations. (Under current law, both the TDC and HHSDC Revolving Funds are continuously appropriated. The budget act, however, has historically included data center expenditure authorities in lieu of continuous appropriations.)

Consolidation Should Improve Services and Reduce Costs…

As noted above, the administration's proposal to consolidate the state's data centers is consistent with previous legislative direction and should ultimately result in improved services and reduced costs. In addition, we agree with the administration's proposal to consolidate a portion of DGS with the consolidated data centers. Many of the DGS TD services—such as voice and data transmissions—are consistent with other services proposed to be offered by DTS. We also concur with the advisability of a review of DTS rates and an annual external financial audit. These two activities would provide additional information to the Legislature on DTS rates and financial stability.

… But Proposal Would Shut Down Legislative Oversight

Despite several promising elements, our review found a number of significant flaws with the remainder of the proposal. These concerns are discussed in detail below.

Continuously Appropriated Revolving Fund Inconsistent With Current Practice. Under current practice, the TDC, HHSDC, and DGS Revolving Funds are all appropriated by the Legislature on an annual basis. These revolving funds have been in place since the early 1970s. The administration has not identified any problems that the annual appropriations have caused for department operations. Yet, the administration proposes to switch from annual to continuous appropriations. Continuous appropriations should be used only when there is no legislative discretion in the payment amounts. The DTS expenses are primarily for hardware and software purchases and employee costs and, therefore, the Legislature has significant discretion over them.

Legislature's Appropriation and Oversight Roles Would Be Limited. For most departments, the Legislature makes annual appropriations and reviews departmental operations. This process is consistent with the Legislature's constitutional responsibilities to fund, oversee, and monitor the activities of the executive branch. The administration, however, proposes to limit the Legislature's budget and oversight roles for DTS. Specifically, the Legislature's budgetary oversight role would be limited to (1) receiving the annual financial audit and (2) approving those DTS expenditures embedded within other department's project budget requests. Since DTS would be off budget, the Legislature would not review the DTS annual budget and its proposed expenditure increases. This role would be fulfilled instead by the TSB. In recent years, the Legislature has taken a number of actions to reduce data center expenditure authorities. For example, the Legislature has reduced HHSDC positions and directed it to lower rates in order to improve its efficiency. Under the administration's proposal, the Legislature would no longer be in a position to take these types of actions.

In addition, as noted above, the DTS Revolving Fund would contain revenues from many different fund sources, including General Fund monies. As a result, TSB decisions regarding the department's expenditures could place financial pressure on a number of funds (including the General Fund)—without legislative approval.

Legislature Would Not Confirm DTS Director. Under current law, the Governor selects the TDC Director, and the California Health and Human Services Agency Secretary selects the HHSDC Director. In addition, the TDC Director must be confirmed by the Senate. For TDC, the process allows the Governor to select a management team while allowing legislative oversight. According to the DTS proposal, TSB would select and appoint the director and the position would not require Senate confirmation. This means that the Legislature would not be able to approve the selection of the DTS Director—reducing the accountability of the department to the legislative branch.

DTS Executive Salaries Would Not Be Reviewed by the Legislature. Under the administration's proposal, TSB would set the salaries of the DTS Director and five executive officers. According to the state CIO, the reason for this TSB salary-setting role is because standard state salaries are not competitive with local government salaries and, therefore, the state is losing staff to these other agencies. According to a 1999 California Research Bureau report, some state IT salaries are lower than comparable local government salaries. We agree with the administration that there may be a salary problem for some state IT positions. We do not, however, agree with the administration's approach to solving the problem. Under current law, the administration can propose salary levels in the annual budget. This allows the Legislature to review proposed salaries to ensure they are adequate to provide the necessary quality of personnel. Since there would be no annual legislative review of the DTS budget, the Legislature would be prevented from reviewing and adjusting DTS executive salaries.

Responsibilities and Composition of TSB Should Be Modified. We do, however, see some value in creating an oversight board for the consolidated data center. Specifically, a board could review the department's operational policies and review its proposed rates and annual expenditure plan before submittal to the Legislature. In addition, a board could monitor the data center's consolidation efforts to ensure minimal disruption to services. For the board to provide good oversight value, the board's composition should include more IT expertise and perspectives outside of the administration.

Recommended Changes to Administration's Plan

Since the consolidation of TDC, HHSDC, and a portion of DGS would improve the state's technology operations and is consistent with previous legislative direction, we recommend that the Legislature approve the consolidation. To address the proposal's significant flaws, we recommend a number of changes (summarized in Figure 1). Specifically, we recommend that the Legislature reject the proposed continuously appropriated DTS Revolving Fund. Instead, we recommend that the Legislature amend the budget to include a DTS appropriation consistent with current practice for the TDC and HHSDC Revolving Funds. The amount for the appropriation for the DTS Revolving Fund should be $235 million. In addition, we recommend that the Legislature revise the role of TSB by eliminating its salary-setting and budget responsibilities and, instead, require TSB to monitor the consolidation effort and review annual rate and expenditure proposals and data center policies. The composition of the board should be modified to emphasize more IT expertise and nonadministration members. To provide legislative review of proposed DTS executive salaries, we recommend that the Legislature direct the administration to include DTS executive salaries in the annual budget. In addition, to ensure legislative and executive branch accountability, we also recommend that the Legislature require the Governor to select TSD's Director subject to Senate confirmation.

Figure 1

LAO Recommendations to Solve Flaws In Proposed Consolidation

Problem	Recommended Solution
• Continuously appropriated revolving fund inconsistent with current practice and would limit legislative oversight.	• Establish an annually appropriated revolving fund.
• Legislature's budgetary and oversight role would be limited.	• Eliminate TSB budgetary role. • Establish an annually appropriated revolving fund.
• Legislature would not confirm DTS Director.	• Allow Governor to select DTS Director, with Senate confirmation.
• DTS executive salaries would not be reviewed by the Legislature.	• Eliminate TSB salary setting role. • Require administration to include executive salaries at the proposed levels in the annual DTS budget.
• Concerns regarding responsibilities and composition of TSB.	• Change TSB responsibilities from budgetary to oversight. • Change composition of TSB to include more IT expertise and perspectives outside of the administration.

OTHER DEPARTMENT ISSUES

Staffing Request Premature

Since the administration has not conducted a position review identifying excess positions resulting from data center consolidation, we recommend that the Legislature reject the request for three additional positions and $266,000. (Reduce Department of Technology Services Revolving Fund by $266,000.)

The budget proposes an expenditure authority increase of $266,000 and three positions to support additional computer storage at the HHSDC site. The purpose of this request is to provide additional staff to install, maintain, and operate new computer equipment.

DTS Has Not Conducted Position Review. When departments consolidate, a position review should be conducted to identify those areas having either excess staff or not enough staff. We believe the administration should conduct such a review and, once completed, it should submit a proposal to either (1) eliminate the excess staff or (2) shift staff to those areas that do not have enough resources. It is our understanding that the administration has not conducted a position review and it is unknown when such a review will be completed. Currently, both TDC and HHSDC perform many similar functions—including supporting comparable hardware systems. Consequently, we would expect some areas to have excess staff. Since it is unclear at this time how many excess positions the consolidation may produce, we believe it is premature to increase DTS staff. For this reason, we recommend that the Legislature reject the request for three additional positions and $266,000.

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 the licensing and examination activities of 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 $31 million and 281 personnel-years (PYs) in 2005-06. This is $1.8 million, or 6.2 percent, more than estimated current-year expenditures and 19 additional PYs. The increase is due to budget proposals to add examiners, continue and expand an online filing program, and continue an investment fraud education pilot program.

Grant Funding for Investment Fraud Education Comes to an End

Because of questionable benefits, we recommend that the Legislature delete $400,000 to continue an investment fraud education program previously supported with grant funds. The Department of Justice currently publishes a guide to help prevent financial fraud. (Reduce Item 2180-001-0067 by $400,000.)

Proposal. The Seniors Against Investment Fraud (SAIF) program trains senior citizen volunteers to provide investment fraud information to other seniors. For four years, DOC has received $400,000 in annual grant funds from the Office of Emergency Services (previously the Office of Criminal Justice Planning) to implement the program. These funds will no longer be available after the current year. As a result, the department requests an augmentation from its regulatory revenues to continue this program.

Definitive Impact Difficult to Demonstrate. A survey analysis of the program reveals that it is difficult to draw definitive conclusions about the program's direct benefits on reducing investment fraud. The survey indicates that the proportion of people who experienced investment fraud was not different between those familiar with SAIF and those who were not. On the other hand, the SAIF-familiar group did experience reduced financial losses and no recent fraud attempts. The analysis notes, however, the possibility that the SAIF-familiar group included people who were already more savvy about investment fraud. Thus, their preexisting experience, rather than their familiarity with this program, could explain the reduced financial losses.

Chosen Methods of Advertising Not Particularly Effective. In addition, a significant portion—more than 20 percent—of the proposal would be for newspaper and radio advertising. The survey indicates modest effects from newspaper advertising in building program familiarity and insignificant effects from radio. These modes of advertising are not particularly effective compared to television, which is significantly more expensive and not part of the proposal.

Department of Justice Program Addresses Investment Concerns. The Department of Justice (DOJ) also administers programs to reduce senior citizen fraud through its Bureau of Medical Fraud and Elder Abuse. Specifically, the bureau partners with the Crime and Violence Prevention Center (also part of DOJ) and the Association for the Advancement of Retired Persons to publish an elder abuse guide that includes a section on financial fraud.

Analyst's Recommendation. Given the lack of proven effectiveness of the SAIF program and DOJ's existing efforts in this area, we recommend that the Legislature not approve DOC's request for $400,000 in funding.

Online Filing Program Double-Budgets Some Equipment Replacement

We recommend that the Legislature reduce the request by $40,000 to account for the double-budgeting of server replacement. (Reduce Item 2180-001-0067 by $40,000.)

Electronic Filings. In 2001-02, DOC implemented a pilot project known as California Electronic Access to Securities Information (Cal-EASI). This project (1) scans images of investment licensees' filings into electronic format and (2) allows the most frequently filed form to be submitted online with credit card payment of the filing fee. This automates access for department employees in different locations around the state, eliminates the need for duplicative databases, reduces processing time, and also enhances public access to confirm licensing.

Reduce Proposal for Overbudgeting. The DOC proposes to continue current funding of $465,000 on a permanent basis for the existing components of Cal-EASI. In addition, the department has a separate proposal to expand Cal-EASI to include two more filings at a cost of $203,000 in the budget year ($174,000 on a one-time basis). The proposal to make the pilot program permanent includes funding (based on a four-year cycle) for replacing servers. At the same time, the expansion proposal includes $40,000 to replace current servers. This double-budgets replacement costs for the first set of servers from the pilot program. Thus, we recommend that the Legislature reduce the one-time equipment allocation in the expansion proposal by $40,000 to account for the double-budgeted servers.

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.

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 (PIT) withholding. In addition, it pays UI and DI benefits to eligible claimants.

The budget proposes expenditures totaling $11.6 billion from all funds for support of EDD in 2005-06. This is a decrease of $550 million, or 4.6 percent, below current-year estimated expenditures. This decrease is primarily due to lower costs in the UI program. The budget proposes $19.2 million from the General Fund in 2005-06, which is unchanged from the current year.

Update on the UI Insolvency

Recent economic growth and the corresponding modest increase in employment have substantially reduced the projected deficit in the Unemployment Insurance (UI) fund. We review the UI fund condition, the status of the state's federal loan, and the need for legislative action.

Program Background. 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.

State law establishes benefit levels to be paid to unemployed workers. The current maximum weekly benefit is $450. 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. (For a more detailed description of program benefits and financing, please see our *Analysis of the 2004-05 Budget Bill*, page F-93.)

The Recent Insolvency. In April 2004, the UI fund became insolvent and the state borrowed $214 million in federal funds in order to pay benefit claims. The loan was repaid in May 2004, a typically high revenue period for the UI fund. Although the Legislature provided EDD with the authority to pay interest on the federal loan, no interest payments were necessary during 2004. This is because federal loans repaid within a federal fiscal year are interest free. (Had the fund become insolvent during the fourth quarter of 2004 requiring subsequent borrowing, the interest would have been due to the federal government. The Legislature provided EDD with budget authority to pay interest had this been the case.)

What Caused the April Shortfall? Three factors contributed to the 2004 insolvency: (1) an inadequate financing structure, (2) a series of statutory benefit increases enacted in 2001, and (3) an unanticipated period of relatively high unemployment.

First, the basic financial structure (benefit payments and tax rates) of the UI program was not sufficiently healthy towards the end of the 1990s economic expansion. In a well-functioning UI system, an extended period of employment growth and economic expansion should result in healthy fund balances and the lowest possible tax rates (Schedule A). As described more fully in the *2004-05 Analysis*, the UI program is financed by employer taxes paid on the first $7,000 of each employee's wages. The tax rate contribution schedules change each year based on the condition of the UI fund. When the fund is strong (low unemployment and correspondingly lower benefit payments), lower tax rate schedules (such as Schedule A) are used. When the fund condition is weak (such as now), higher rate schedules (such as Schedule F+) are used. In 2000, after several years of relatively low unemployment and robust economic growth, the fund condition never improved past triggering Schedule C. In other words, even at the best of economic times, the fund condition reflected only marginal health.

The second contributing factor was a series of statutory benefit increases first enacted in 2001. 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 to the following amounts: 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. 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 rates paid by employers. 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. In other words, EDD projected that under the highest F+ tax schedule, the fund would weaken substantially, but would remain solvent.

The third factor was higher-than-anticipated unemployment rates during 2002 and 2003. Essentially, at the time that Chapter 409 was enacted, the forecasts did not contemplate higher-than-normal unemployment in 2002, 2003, and 2004.

In conclusion, higher statutory benefits added to an inadequately financed UI system, in conjunction with higher than anticipated unemployment, resulted in the April 2004 shortfall.

Smaller Shortfalls Now Anticipated Compared to Prior Forecasts. Although the fund experienced a deficit of $214 million in April 2004, previous estimates made in 2004 and 2003 suggested a much deeper problem. Specifically, EDD's April 2004 forecast anticipated a shortfall of $1 billion in the first quarter of 2005, rising to almost $2 billion by the first quarter of 2006. Since that time, fund revenues and expenditures have moved closer toward balance.

In October 2004, EDD issued its new UI forecast. Based on recent economic improvements, this forecast projects a $340 million shortfall in the first quarter of 2005, and a calendar year-end positive balance of just over $130 million. For 2006, EDD anticipates a $600 million shortfall during the first quarter, and a year-end deficit of about $90 million.

The federal loan will allow California to make benefit payments without interruption during 2005, and the loan should be interest free based on the current projections. For 2006, the state may owe interest to the federal government because borrowing could be necessary during both the first and fourth quarters based on EDD's projections. The budget for 2005-06 seeks authority to expend up to $3 million from the contingent fund on federal interest and fees.

Applying the LAO's Economic Forecast to the UI Fund Condition. In reviewing the UI fund condition report prepared by EDD, we found that EDD assumed significantly higher levels of unemployment than we did in our current fiscal forecast. Specifically, we project that during 2005 and 2006, California's unemployment rate would be 5.4 percent and 5.6 percent, respectively, whereas EDD projected the rates to be 6.1 percent and 5.9 percent. We requested EDD to recalculate the UI fund balances in 2005 and 2006 using our unemployment forecast. Based on this approach, the UI fund would have a positive balance of about $550 million at the end of 2005 and $880 million at the end of 2006.

Situation Is Still Precarious. As described above, the UI fund is no longer projected to experience deep deficits. Under EDD's own projection, there will be a modest deficit of $93 million at the end 2006. Under our economic assumptions, the balance would be a positive $880 million. Nevertheless, the situation is precarious. Any economic disruption and corresponding spike in unemployment could plunge the program into insolvency.

Current Situation Unsustainable Through Full Economic Cycle. Although recent economic improvement means that a short-term crisis has been averted, the current UI financing system cannot be sustained over multiple economic cycles of expansion and contraction. During periods of economic recovery, a healthy UI system should allow the state to move away from the F+ tax rate toward lower tax rate schedules. Even if unemployment remains at 5.5 percent or less during 2007and 2008 (as we forecast), the UI fund balances will not move above $2 billion and the state will remain on the F+ tax schedule. Further, the federal government believes that a prudent reserve for the UI fund would be in excess of $8 billion, an amount that is unachievable under the current financing system.

Negative Consequences of Inaction. There are two negative consequences of not addressing the precariousness of the UI funding situation. First, in the short run there is an equity issue for employers related to continued use of the F+ tax rate schedule when the fund condition is weak. Specifically, the F+ schedule means that employers with more steady employment pay more in relative terms than do cyclical employers whose workers use the program more frequently. (For a more detailed discussion of UI tax rate schedules, please refer to our *2004-05 Analysis*.) Second, weak balances in the UI program mean that the state has no cushion against falling into another period of insolvency. Protracted insolvency poses two additional costs: interest payments to the federal government and higher federal administrative tax rates for the UI program. For example, New York state's UI program remains insolvent and beginning in 2005, New York employers paid higher Federal Unemployment Tax Act (FUTA) taxes. A prolonged insolvency (more than two years) would have a similar impact on California's FUTA taxes.

Options for the Legislature. In order to return the UI system to a solid financial footing, the Legislature has essentially four choices: (1) increase the taxable wage base, (2) increase the tax rate schedules, (3) reduce benefit payments, or (4) some combination of the previous three options. Unemployment insurance benefit levels and tax rates are policy issues for the Legislature.

Comparison to Other States. Last year, we reviewed benefit levels and tax rates in other states and concluded that California's average benefit was slightly below the U.S. average and that California's taxable wage base was relatively low. Data for 2004 suggest that California's average weekly benefit is now about equal to the national average. No additional data on the taxable wage base by state were available from the U.S. Department of Labor.

Governor's Proposal. The *2004-05 Governor's Budget* did not propose a solution to the impending UI insolvency. During 2004, the administration worked with stakeholders from business and labor to arrive at a consensus on UI benefits and taxes in order restore financial stability. However, no consensus was reached on this issue. Although the *2005-06 Governor's Budget* seeks authority to expend up to $3 million on federal interest payments and fees, it provides no suggested solution to the fiscal precariousness of the UI fund.

Conclusion. Recent economic improvements mean that California's UI fund has averted a deepening financial crisis. Nevertheless, the current system of benefits and revenues will be difficult to sustain over future business cycles. A recession would quite likely plunge the system quickly into insolvency resulting in interest costs and the potential for higher FUTA taxes on employers. In order to put the UI system on solid financial ground, the Legislature must either reduce benefits, raise the tax base, or some combination of benefit reductions and revenue increases.

Improving Legislative Oversight for Unspent WIA Funds

Because state Workforce Investment Act (WIA) discretionary funds may be used for many purposes, we recommend deleting a proposed provision which would limit the Legislature's authority to set priorities for unexpended WIA funds from prior years.

Background. Each year, 15 percent of the federal Workforce Investment Act (WIA) funds (referred to as discretionary funds) are available to be spent on a range of state workforce employment activities: state administration, statewide initiatives, current employment services programs, and competitive grant programs. (The remaining 85 percent is allocated to local Workforce Investment Boards.) The state discretionary funds are usually in the range of $65 million to $85 million each year. The Legislature appropriates these funds in the annual budget act.

Budget Control Language for Unspent WIA Funds. Budget control language in the *2004-05 Budget Act* gives the administration broad authority to expend in the current year WIA discretionary funds which were not spent in the prior year. Specifically, Provision 1 of Item 7100-001-0869 of the *2004-05 Budget Act* permits the administration to spend these funds by simply notifying the Legislature without an opportunity for it to review the proposal. This language, which notwithstands Section 28 (which typically governs the use of unanticipated federal funds), is continued in the proposed *2005-06 Budget Bill*.

Administration Obtained Budget Authority for $21.7 Million. In December 2004, the Director of Finance notified the Legislature of $21.7 million in unspent WIA funds from 2003-04. Pursuant to the language discussed above, this notification creates expenditure authority for these funds without input from the Legislature.

Provision 1 Is Flawed With Respect to WIA Funds. Provision 1 is actually part of another budget item pertaining to the administration of UI benefits, which is a caseload-driven entitlement program. When the workload for administering UI benefits increases, it is appropriate to increase the corresponding budget authority for administration. However, this logic does not apply to WIA discretionary funds because workload of WIA administration is not caseload driven and WIA-funded programs are not entitlements. On the contrary, WIA funds are for discretionary projects, which the Legislature should have an opportunity to review.

Section 28 Should Apply to Unanticipated WIA Funds. Section 28 governs the expenditure authority for unanticipated federal funds. Specifically, it establishes a process by which the administration notifies the Legislature of the receipt of unanticipated federal funds and provides the Legislature the opportunity to review the administration's proposed use of the funds. It authorizes their expenditure after 30 days notification to the Legislature that four specified conditions have been met. Specifically, under Section 28 the administration must demonstrate unanticipated federal funds (1) will be expended in accordance with state law, (2) are made available for a specified purpose, (3) do not entail any state matching commitment, and (4) and must be expended prior to the next budget act. We believe these conditions should be applied to WIA discretionary funds in order to provide the Legislature with the opportunity to review the proposed uses of those funds. Accordingly, we recommend that the Legislature delete the existing Provision 1 of Item 7100-001-0869. This deletion would effectively apply Section 28 to this item, assuring the Legislature that expenditure of unanticipated WIA funds will be consistent with legislative priorities.

Restoring Auditors and Collectors to Increase Revenue

We recommend adding 50 auditor and collector positions to the Employment Development Department (EDD) in order to collect an additional $6 million in General Fund revenues, $2.2 million in Unemployment Insurance fund revenues, and $1.2 million in special fund revenues. This proposal provides a net benefit of $3.4 million to the General Fund. We further recommend adoption of supplemental report language requiring EDD to report to the Legislature on the actual amount of additional revenue collected.

Background. Among other responsibilities, EDD collects from employers the payroll taxes for UI, employee contributions for DI, PIT withholding, and payments to the employment training fund (ETF). Since 1998-99, EDD has lost 165 auditor and collector positions. Most of these reductions were pursuant to Section 4.10 of various budget acts. (Section 4.10 required the administration to achieve statewide departmental savings.) Although other revenue generating positions at the Franchise Tax Board (FTB) and the Board of Equalization were exempted from Section 4.10 reductions, this was not the case at EDD. The Governor's budget proposes to increase staff at FTB in 2005-06 in order to increase tax compliance, and scores additional revenues of $77 million as a result of this effort.

Estimated Additional Revenues. In view of other budget proposals related to tax compliance and the disparate treatment of auditor/collector positions among the tax agencies, we asked EDD how much revenue would be generated if it restored 50 of the lost auditor and collector positions in the budget year. The department estimated that with these additional positions, it would collect a total of $6 million ($2.6 million General Fund, $2.2 million UI fund, $1.1 million DI fund and $0.1 million ETF) in additional revenues during 2005-06. The estimate is based on historical collection experience and appears reasonable. The revenue estimates allow for start-up activities and training during the first half of the fiscal year, and most of the actual revenues would be collected in the latter half of 2005-06.

Estimated Costs. The EDD estimates that the total cost for 50 new auditor and collector positions would be $3.6 million, including salaries, benefits, equipment, and overhead. This cost could be supported by the General Fund and the DI fund. Based on the amount of DI revenues collected, about 30 percent of first-year costs could be allocated to the DI fund. Thus, General Fund costs would be about $2.6 million and DI costs would be about $1 million. (Although the UI fund would benefit from these collections, no costs can be allocated to UI because UI administration funds are capped by the federal government.) The ratio of General Fund revenues to the General Fund costs would be about 2.3 to 1 in the first year rising to roughly 3 to 1 in the second year.

Add Positions, Document Results. Unlike other revenue collection agencies such as FTB, EDD lacks a systematic method for identifying the strongest audit and collection leads with the biggest payoff. While the department lacks the ability to calculate a precise benefit/cost ratio for additional audit and collection resources, we think there is sufficient evidence to warrant funding an increase in these activities. Accordingly, we suggest that the Legislature restore 50 auditor and collector positions and measure the increased revenue that is generated before authorizing any additional positions.

Analyst's Recommendation. We recommend that the Legislature authorize 50 auditor and collector positions at a total cost of $3.6 million ($2.6 million General Fund and $1 million DI fund). This would result in an additional $6 million in General Fund revenues, $2.2 million in UI fund revenues, and $1.2 million in special fund revenues. The net benefit to the General Fund would be $3.4 million. We further recommend that EDD report on the revenues collected from these additional positions. Based on this report, the Legislature would be in a better position to determine whether it would be cost-effective to add more auditor positions. The following supplemental report language is consistent with this recommendation:

> By January 10, 2007, the Employment Development Department shall report to the Legislature on the amount of additional revenue generated by the new auditors and collectors added during 2005-06.

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 $303 million and 1,823 positions in 2005-06 for the department, including $116 million from the Agriculture Fund and $100 million from the General Fund. The proposed General Fund expenditures are $4 million, or 2 percent, over estimated current-year expenditures, due to augmentations of $2.7 million for threats to food production (discussed below) and $1.3 million to purchase new equipment for a veterinary lab. The General Fund budget also includes $8.1 million to provide ongoing funding for the Mediterranean Fruit Fly (Medfly) Preventative Release Program (PRP).

Funding Options for the Mediterranean Fruit Fly Preventative Release Program

To the extent that the Legislature chooses to assess a fee to cover the state's share of costs of the Medfly Preventative Release Program, we offer a number of considerations concerning a fee structure.

The *Supplemental Report of the 2004-05 Budget Act* requires the Legislative Analyst's Office to review the department's 2003 report, *Preventing Biological Pollution: The Mediterranean Fruit Fly Exclusion Program*. Below, we provide comments on the report and assess options for funding of the program.

Background

State Fighting Flies for 30 Years. The Medfly has the ability to infest over 200 different kinds of fruits and vegetables. The larvae feed inside the produce, making it unfit for human consumption. The department began efforts to control the impact of the Medfly on California's agricultural industry in 1975. Since 1980, the state has spent over $150 million from the General Fund to support this effort, with a similar amount provided by the federal government. To fight the pest, the department originally used aerial and ground spraying of pesticides but now relies on sterile Medfly releases.

Current Program. The current PRP began in 1996 and involves raising sterile Medflies and releasing them regularly within high-risk areas. Most of the program's releases have been in the Los Angeles Basin. These sterile flies mate with any wild fertile female flies that have been introduced into the area. Reproduction is curbed because the eggs resulting from this pairing with a sterile male will not hatch. Over the past several years, new infestations of wild fertile flies in the release zone have dropped from an average of seven to just three per year. The program is based on the assumption that the state is continuously at risk of infestation from the Medfly.

Proposal to Make Program Permanent. The current Medfly program was originally due to sunset at the end of 2000-01. Each subsequent budget has extended the program for one additional year. The Governor's budget proposes to fund Medfly control on an ongoing basis and provides $8.1 million in General Fund support for this purpose. Total program costs are about $16 million annually, shared equally between the state and the federal government.

Report Describes Funding Options. In 2003, the department released a report titled, *Preventing Biological Pollution: The Mediterranean Fruit Fly Exclusion Program*. The report lays out seven options for funding the Medfly Exclusion Program:

- ***Federal Funding***. The report discusses the option of negotiating full federal funding for the program.
- ***General Fund.*** Under this option, the state would continue to fund the state's share of the program. This is what the Governor's budget proposes.

- ***Agriculture Fund.*** The repost discusses the option of funding the program with existing Agriculture Fund monies. The use of the funds, however, are restricted for specified purposes by state law. Therefore, the funding would not be available for this program.
- Fees on retailers that sell produce.
- Fees on consumers' food purchases.
- Fees on international travelers and commerce.
- Fees on domestic growers.

The 2004-05 supplemental report requests that our office further explore the option of assessing international travelers and commerce, as well as identify and evaluate additional options if available.

Assessing International Travelers and Commerce Not Feasible

According to the report, international travel and imported products account for all of the pathways by which Medfly and other food-borne pests and diseases can enter the United States. Under this option, a fee would be assessed upon international travelers and commerce. At the time the report was released, the department suggested this option was the most favorable.

Based on provisions of the U.S. Constitution, Congress is granted the sole power to regulate commerce with foreign nations. This option, therefore, is not feasible through state legislation. It would require congressional action and possible revisions to existing international agreements governing trade and travel. The department now concurs that the option would be impossible to implement unilaterally at the state level.

Other Options Considered

We reviewed other options put forward by the department. While receiving additional federal dollars for the program would be the most desirable alternative, the federal government has yet to show any willingness to eliminate the matching funds requirement of the program. The department's second option—General Fund share of costs—has been used in the past to fund the program. The Legislature, however, has consistently raised concerns regarding making the General Fund a permanent source of funding. The various fee options—other than the one on international commerce—are potential funding sources. We discuss the option of a fee in more detail below.

Key Considerations for an Industry Assessment

Field data indicate that the PRP is successfully controlling the Medfly population in Southern California. By preventing the establishment of Medfly populations, the PRP protects a variety of food industries. The CDFA estimates that in the absence of such a program, the direct crop losses as a result of Medfly damage could range between approximately $150 million to $300 million annually. Clearly, the control of Medfly populations generates benefits to specific agricultural industries. It is reasonable, therefore, that the agricultural industries that most benefit from the program contribute to its support. It is for this reason that we have recommended in recent years the enactment of an assessment program to distribute the nonfederal costs of the PRP to those industries (see for instance the *Analysis of the 2003-04 Budget Bill*, pages F-137 to F-138). If the Legislature chooses to pursue this approach, we offer a number of key considerations below.

Should Fee Be Statewide? The department questions whether it is equitable to assess a fee on commodities statewide given that the current control effort focuses on the Southern California region. An infestation in any part of California, however, could result in other states or countries refusing to purchase California agricultural commodities. The agriculture industry throughout California, therefore, benefits from the continuation of the program.

Which Commodities Should Be Subject to a Fee? The department reports that over 200 commodities are subject to Medfly infestations. Assessing each of these commodities could create excessive administrative costs. The fee structure instead could focus on a limited number of key products with the greatest economic interest in the prevention of a Medfly infestation.

Point of Assessment? As noted in the department's report, fees could be assessed at a variety of points along the food supply—at the grower, retailer, or consumer levels. Assessing a fee at the grower level might make the most sense—reflecting that the control of the Medfly is a cost of doing business like other pest control activities.

Should Assessments Vary by Commodity? In developing a fee structure, the department would need to consider the most equitable and efficient way to assess the fees given the differences among the commodities. For example, the department would need to consider whether a fee should be based on weight, value, or some other method of measurement. Many of the commodities already pay into the Agriculture Fund for other purposes. The department, therefore, could build upon these existing fee structures to recover the costs of the PRP.

Beyond the Medfly? Over time, the state has been involved in the eradication and control of a number of agricultural pests, such as the Mexican fruit fly and the glassy-winged sharpshooter. The Legislature may wish to consider moving beyond a pest-specific fee. Instead, the state could develop an agricultural fee structure that would make funding available each year for the most urgent pest efforts.

Department Could Handle Details. The department, as the expert in this area, would be the most appropriate entity to develop a specific fee structure. To the extent that the Legislature chooses to assess a fee to cover the state's costs of the PRP, the Legislature should (1) not approve the General Fund request for this program and (2) instead enact legislation directing CDFA to develop a reasonable fee structure to generate sufficient funds to match federal support for this program.

OTHER DEPARTMENTAL ISSUES

Position Information Not Available

We withhold recommendation on the department's proposed Agriculture Fund budget of $116 million and 484 positions pending receipt of a complete report regarding the positions supported by the fund. The report submitted by the department did not include most of the required information.

Background. In the *Analysis of the 2004-05 Budget Bill* (please see pages F-103 to F-110), we noted that the department's management of its budgeted positions significantly deviated from standard state procedures. About half of CDFA's positions, those funded by the Agriculture Fund, had been created at the discretion of the department—without approval of either the Legislature or the Department of Finance.

Legislature Requires Department to Conform to Standard State Practices. The 2004-05 budget package requires that the department conform with standard state practices regarding the creation and management of its positions. In addition, the department was required to report to the Legislature by January 10, 2005 on these positions. Specifically, the department was required to provide a description of the positions—by program, classification, and source of funding—as well as a complete description of the workload for the positions.

Department's Report Incomplete. The department, as required, appropriately established all permanent positions with the State Controller's Office. In addition, the department provided the Legislature with a report. The report, however, does not provide any information on the workload for the positions. The department instead provided general job descriptions adopted by the State Personnel Board for all relevant classifications. There is no information available on the work performed by the positions at CDFA. For example, the report provides a general description of the scope of work that may be performed by the Government Program Analyst series of positions. According to the report, these positions are used to perform a wide variety of consulting and analytical assignments. The report does not, however, provide any information on how the positions are achieving specific agricultural objectives of the department. Given that the department had created these positions outside of the authority of the Legislature, it is critical that the Legislature be provided the opportunity to review the justification for these positions. The department's current-year budget was approved with the understanding that this information would be forthcoming. We therefore withhold recommendation on the department's Agriculture Fund budget of $116 million and 484 positions pending the receipt and review of a complete report of these positions, as required by current law.

Animal Control Mandate

In 1998, the Legislature enacted legislation to prevent the euthanization of adoptable stray animals. In 2001, this legislation was determined to be a state-reimbursable mandate. The Governor's budget proposes $13.9 million in General Fund spending to cover the costs of the mandate. Our estimate, however, shows that an additional $6.2 million is needed to fully cover the costs of this mandate in 2005-06. We recommend that the Legislature direct the Commission on State Mandates to revise the parameters and guidelines of the mandate to lower its costs.

Local Agencies Responsible for Animal Control. Local government animal control agencies care for stray and surrendered animals in California communities. Such care includes housing, medical care, and vaccinations. These agencies also pursue the successful adoptions of the animals in their care and euthanize those animals that are not placed.

Legislation Aims to Reduce Euthanizations of Stray Animals. Seeking to reduce the euthanization of adoptable stray animals, the Legislature enacted Chapter 752, Statutes of 1998 (SB 1785, Hayden). Prior law provided that no dog or cat impounded by a public pound or specified shelter could be euthanized before three days after the time of impounding. Chapter 752 requires the following:

- An increase from three days to four to six business days, as specified, in the holding period for stray and abandoned dogs and cats.
- A holding period of four to six business days for other specified animals.
- The verification of the temperament of feral cats.
- The posting of lost and found lists.
- The maintenance of records for impounded animals.

- The release of animals to nonprofit rescue or adoption organizations.
- "Necessary prompt veterinary care" for impounded animals.

Legislation Found to Be Reimbursable Mandate. In 2001, the Commission on State Mandates (CSM) determined that Chapter 752 imposed a reimbursable state mandate by requiring, among other activities, that cats and dogs be cared for longer than the three days previously required by law.

Proposed Spending Does Not Fully Fund Mandate Costs. The Governor's budget proposes $13.9 million in General Fund spending to cover the costs of the mandate. The estimate of $13.9 million was based on a point in time, and local governments were still able to submit claims after the estimate was developed. Under the provisions of Proposition 1A passed by the voters in November 2004, a mandate must be fully funded or suspended. We have reviewed the most recent claims and estimate that—in order to fully fund this mandate in 2005-06—the Legislature would need to appropriate a total of $20.1 million, an increase of $6.2 million from the Governor's budget.

Costs Exceed Legislative Expectations. The Legislature did not anticipate incurring significant, if any, state-reimbursable mandate costs when it enacted Chapter 752. Instead, the Legislature expected that most, if not all, local agency increased costs to care for animals held longer than three days would be offset by (1) increased adoption and pet recovery fees and (2) savings from avoided euthanizations. Given its high costs, both our office (please see the *2003-04 Analysis* pages F-133 to F-137) and the Bureau of State Audits (BSA) have reviewed the mandate's claims.

Both reviews found areas of ambiguity within the mandate's parameters and guidelines (Ps&Gs) that allow local agencies to claim some costs that appear to exceed the range of activities mandated by Chapter 752. For example, the BSA notes that the Ps&Gs allow local agencies to receive reimbursement for capital costs not associated with Chapter 752. In addition, our review found that the Ps&Gs are not sufficiently explicit regarding the requirement that offsetting savings and revenues be deducted from reimbursement claims.

Recommend Revising Ps&Gs. If the Legislature wishes to maintain all the requirements of Chapter 752, we recommend the Legislature direct the CSM to revise the Ps&Gs to make changes addressing the issues identified in the BSA's report and the *2003-04 Analysis*. If the Legislature instead chooses to leave the mandate unchanged, an increase of $6.2 million General Fund is needed to fully fund the mandate in 2005-06.

Emerging Threats to Food Supply

We recommend the deletion of a $2.7 million General Fund request for reducing threats to the food supply. Instead, we recommend the administration resubmit a request that reflects a coordinated effort with the state's two primary homeland security departments. (Reduce Item 8570-001-0001 by $2.7 million.)

Proposal. The department provides the state's first response to introductions of livestock diseases and contamination of the food supply at the production level in the state. The Governor's budget proposes a $2.7 million increase to the department's General Fund budget and 17 positions for start-up costs to address threats to food production in California. These threats include diseases that effect both animals and humans and acts of terrorism. The request assumes the approval of an additional $15.9 million in General Fund support in 2006-07 for full implementation of the program. The proposal includes start-up funding for seven new programs in 2005-06, with four additional programs to be launched in 2006-07.

Administration Fails to Justify Request. Such a substantial policy proposal should be accompanied by a significant level of supporting detail, particularly as to how these efforts fit with the state's current strategy regarding the threat of terrorism. The administration, however, provides little justification with regard to this request. Generally, the request is a description of various needs, but lacks adequate details regarding how the department proposes to address those needs. For example, the department is proposing to start a "rural-urban education and surveillance" program at a cost of more than $3 million over the next two years. The department reports that urban areas are rapidly encroaching on commercial agriculture. According to the department, the encroachment of urban areas upon commercial agricultural areas puts the state's poultry, livestock, and food supply at increased risk of disease. The request for this program includes a list of positions with brief descriptions of tasks to be performed. The request, however, does not show how these positions would reduce the identified problem.

In other cases, it is not clear whether the department is proposing new activities or simply supplementing existing resources. For example, the department is proposing to upgrade its current field communications system and data management program at a cost of more than $1 million over the next two years. The department identifies some existing information technology problems common to many state departments. The request, however, fails to describe how the additional resources pertain to limiting the threats to the food supply.

Request Does Not Reflect Statewide Strategy. Based on our review of the proposal and information provided by the department, the request fails to reflect coordination with the two agencies administering the state's current efforts related to terrorism—the Office of Homeland Security (OHS) and the Department of Health Services (DHS). (Please see the "Crosscutting Issues" section of this chapter for a more detailed discussion of homeland security funding.) These two agencies provide annual federal homeland security grants to state departments for security priorities.

Other Fund Sources Available. Homeland security grants would be an appropriate funding source for efforts in the department related to bioterrorism. In fact, the OHS reports that agricultural terrorism will be one of the funding priorities in the coming year. In addition, OHS administers the state's Antiterrorism Fund, which is funded from proceeds from the sale of California memorial license plates. Half of the amount in the fund may be used by agencies other than OHS for antiterrorism activities. For any expenses not eligible for federal funding, the Antiterrorism Fund would be an appropriate source of funds. We note that the Antiterrorism Fund has $1.8 million available in 2005-06 for non-OHS expenditures.

Recommend Resubmittal of Proposal. We recommend the Legislature reject the administration's current request. Instead, the administration should resubmit a request that reflects a coordinated effort with DHS and OHS. The proposal should fully utilize available funds outside of the General Fund. Moreover, the proposal should provide sufficient justification to demonstrate how the funds will be used effectively.

MILITARY DEPARTMENT
(8940)

The Military Department is responsible for the command and management of the California Army and Air National Guard. To support the operations for a force of about 20,000 personnel, the department maintains a headquarters complex in Sacramento, 118 armories, 32 equipment maintenance facilities, and 10 air bases throughout the state.

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

The budget proposes $673 million ($33 million General Fund) in expenditures. Most of the Military Department's budget, about $571 million, comes from federal funds.

Oakland Military Institute

Since the Oakland Military Institute has been able to increase enrollment and operate for two years with reduced Military Department personnel, we recommend that the Legislature reject the proposed General Fund increase of $1.3 million. (Reduce Item 8940-001-0001 by $1.3 million.)

The budget requests an additional $1.3 million in General Fund support for the Oakland Military Institute (OMI). The request would reestablish 12 positions that were eliminated in the 2003-04 and 2004-05 budgets.

Background. The OMI is a joint effort of the Military Department, the City of Oakland, and the Oakland Unified School District (OUSD) for a military charter school for Oakland students in grades 6 to 10. The purpose of the school is to promote the academic achievement of disadvantaged students through a strictly structured and disciplined environment. In addition to the standard state curriculum, students receive instruction in military subjects, such as military customs, physical training, drill, and map reading. Military personnel are responsible for OMI administration, including budgeting, program management, policy development, and coordinating campus security. In addition to these duties, military staff escort students to and from the school, provide instruction in military subjects, and serve as classroom mentors. The OUSD provides instructional staffing, books, and educational supplies. The City of Oakland provides facilities, furniture, and computers. Currently, OMI has 425 students.

School Has Expanded Despite Budget Reductions. In 2002-03, OMI had a General Fund budget of $2.4 million. Budget reductions in 2003-04 and 2004-05 reduced OMI's budget—resulting in a General Fund appropriation of $1.3 million in 2004-05. Due to these budget reductions, the Military Department reduced its OMI-assigned staff by 12 positions to its current level of 10 positions. Even with these budget reductions, OMI increased its enrollment this year by 100 additional students. In the budget year, OMI plans to include an 11th grade for the first time.

Recommend Rejecting Proposal. The OMI continues to conduct its programs with reduced Military Department personnel. If OMI chooses to expand in the budget year, it should do so with resources other than the General Fund. A denial of additional General Fund dollars for OMI does not preclude OUSD or the City of Oakland from using existing charter school funds or other sources (including local funds and private donations) to expand the school. Consequently, we recommend that the Legislature reject the proposed augmentation.

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 2005-06 tax relief of $539 million appropriated through the budget bill. This represents a sharp decline from the $668 million budgeted expenditures in the current year.

Prior to 2004-05, the largest component of tax relief was the vehicle license fee (VLF) backfill paid to local governments to compensate for their revenue losses due to the legislated reduction in the VLF. This fee was reduced from 2 percent of vehicle value to 0.65 percent beginning in 1998, with General Fund backfill compensating local governments for the revenue difference between the two rates. Beginning with the current year, local governments are receiving additional property taxes—which previously went to K-12 education—to make up for the loss in VLF revenues. This revenue "swap" will require additional annual school spending from the General Fund.

The largest tax relief program is now the homeowners' exemption ($440 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 $6.8 million, or 1.6 percent, over the amount budgeted for 2004-05. Other tax relief programs include senior citizens' assistance programs and subventions to local governments for open space preservation.

CHANGES PROPOSED FOR SENIOR CITIZENS' ASSISTANCE

Given the risk to the General Fund that could result from an unexpected expansion of the property tax deferral program, we recommend that the Legislature direct the Department of Finance to document the likely additional participation in this tax relief program.

There are currently three tax assistance programs available for eligible senior citizens in the state. Each of the programs is tied—directly or indirectly—to property taxes paid by participants in the programs. The programs are:

- ***Senior Citizens' Property Tax Assistance.*** This program provides grants directly to homeowners in order to offset a portion of their property tax bill. The program is open to homeowners 62 years of age or older, and to blind or disabled residents regardless of age. In 2003-04, the program had 156,506 participants.
- ***Senior Citizens' Property Tax Deferral Program.*** This program allows eligible seniors or disabled homeowners to essentially borrow from the state to pay a portion of their property tax levies. The state places a lien on the property so that when the property is eventually sold, the state is repaid. In 2003-04, there were 8,100 participants in the program
- ***Senior Citizen Renters' Tax Assistance Program.*** This program provides grants directly to renters in order to offset a portion of the property taxes that are passed on to them in the form of increased rent. The program is open to renters 62 years of age or older, and to blind or disabled residents regardless of age. In 2003-04, the program had 493,752 participants.

Program Eligibility Was Expanded

In 1999-00 through 2001-02, the Legislature made several changes to the senior citizens' assistance programs. These changes included a one-time boost in benefits, a rise in the income level for eligibility, and a permanent increase in the level of benefits. Specifically, beginning in 1999-00, income eligibility was increased from about $13,000 annual household income to about $33,000. These amounts were also required to be indexed based on the cost of living. (Absent the proposed budget changes noted below, the household income threshold for these programs for 2005-06 would be about $38,000.) As part of the 2001-02 budget package, benefit payments were increased by about 45 percent on an ongoing basis. Combined, these tax assistance increases resulted in additional expenditures of about $160 million annually.

Proposed Changes in Seniors' Tax Assistance

The administration has proposed significant changes in the senior citizens' assistance programs. The change which results in the greatest budget savings is the proposal to roll back income eligibility for the Senior Citizen Renters' Tax Assistance Program to $13,200, or about where it was in 1998. This would result in savings in 2005-06 of slightly in excess of $100 million. The proposal assumes that, as a result of this change, the number of participants in the program would decline by 25 percent or about 125,000.

In addition, the administration proposes to eliminate in its entirety the Senior Citizens' Property Tax Assistance Program. It has also proposed raising the income threshold for the Senior Citizens' Property Tax Deferral Program to $39,700 from about $38,500. The net budget impact of these two program alterations is a General Fund savings of about $35 million.

The $4.7 million increase proposed for the deferral program is presumed to account for program expansion due to the rise in the income eligibility threshold discussed above and additional participation from those currently in the property tax assistance program. However, the proposed increase in funding does not appear to adequately account for this latter factor. While it is difficult to estimate this behavioral effect, even a small percentage increase in participation in the deferral program would have significant budgetary implications. For instance, assuming only 5 percent (7,826) of those participating in the Senior Citizen Property Tax Assistance Program chose to participate in the deferral program, there would be additional costs of over $10 million. In this situation, the tax relief item would be underbudgeted. Given the risk to the General Fund that could result from an unexpected expansion of the property tax deferral program, we recommend that the Legislature direct the Department of Finance to document the likely additional participation in this tax relief program.

Considerations for the Legislature

In previous publications, we have presented as an option reducing spending for the Senior Citizens' Property Tax Assistance Program (see *Options for Addressing the State's Fiscal Problem*, February 2002, page 94). The passage of Proposition 13 provided a significant amount of property tax relief, particularly among homeowners who tend to remain in the same residence—such as senior citizens. As a result, the Legislature may feel that it can reduce the tax subsidies provided under this item without undue harm to seniors. Nevertheless, the administration's proposed budget change would represent a substantial reduction of benefits for elderly and disabled residents in the state. As such, the Legislature may wish to consider other alternatives to the Governor's proposals. For instance, the Legislature could consider phasing down the benefits in a more gradual manner or raising the income limits on the deferral program even higher than that proposed by the Governor.

NEWLY IDENTIFIED MANDATE REVIEW

Chapter 1124, Statutes of 2002 (AB 3000, Budget Committee), requires the Legislative Analyst's Office to review each mandate included in the Commission on State Mandates' (CSM's) annual report of newly identified mandates. In compliance with this requirement, this analysis reviews the mandate entitled "Redevelopment Agencies—Tax Disbursement Reporting."

County Auditor Redevelopment Tax Report Mandate

State law requires redevelopment agencies to deposit 20 percent of their tax increment revenues into Low and Moderate Income Housing Funds and use these monies to develop affordable housing. In 1997, the Legislature's Task Force on Redevelopment Agencies' Affordable Housing Reports concluded that it was difficult for private and public agencies to monitor redevelopment agency compliance with this state law because data regarding tax increment revenues were not readily available. To address this problem, the Legislature enacted Chapter 39, Statutes of 1998 (SB 258, Kopp), requiring county auditors to prepare annual tax disbursement statements for each redevelopment agency project area.

In November 2002, the CSM determined that county auditor work to prepare these tax statements was a state-reimbursable mandate and estimated the statewide cost of this mandate to be $65,300 (for costs through 2004-05).

Reporting Mandate No Longer Needed

Because other sources of data regarding redevelopment tax increment revenues have become readily available in recent years, we recommend the Legislature repeal this mandate by deleting the requirement that auditors prepare these reports.

The State Controller's Office (SCO) annually publishes detailed reports on the financial transactions of redevelopment agencies, including all information that Chapter 39 requires county auditors to report. In 1997 (when the Task Force undertook its review), these SCO reports frequently were delayed for prolonged periods. Recent SCO reports, however, have been released and posted on the Internet on a timely basis (within ten months of the end of the fiscal year, as specified in state law).

In addition to the SCO reports, state laws require redevelopment agencies to obtain independent annual audits that (1) detail all financial transactions and (2) include an auditor's opinion of the agency's compliance with applicable state laws and regulations. While this audit requirement existed in 1997, guidelines for preparing these audits have been clarified and expanded in recent years.

Because of the availability of these alternative sources of data, Chapter 39's requirement that county auditors prepare annual tax disbursement reports for redevelopment agencies has become redundant. We note, for example, that the state agency responsible for monitoring redevelopment agency housing law compliance (the Department of Housing and Community Development) does not use these county auditor reports for its work. Accordingly, we recommend the Legislature repeal this mandate.

LOCAL GOVERNMENT FINANCING (9210)

This budget item contains funding for four purposes:

- ***Citizens' Option for Public Safety (COPS).*** The COPS program was created in 1996 to provide local governments with funds for law enforcement. The program was expanded in 2000-01 to include funding for the Juvenile Justice Crime Prevention Act. The 2004-05 budget provides $100 million for each component. The Governor's budget proposes $100 million for COPS, the same level of support as the current year. Funding for juvenile programs is reduced by $75 million and $25 million is shifted to the Board of Corrections for distribution to local governments.
- ***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 through 2006-07. The budget provides $54.3 million for grants in 2005-06, a reduction of $5.7 million from 2004-05 levels.
- ***State-Mandated Local Programs.*** Funding for nine state mandates is appropriated under this item. The administration proposes to suspend local governments' obligations to carry out six mandates and provides $2.4 million for the other three. We discuss these proposals below. (We review the administration's overall mandate proposal and discuss the impact of Proposition 1A—approved by the voters in November 2004—in "Part IV" of *The 2005-06 Budget: Perspectives and Issues.)*
- ***Special Supplemental Subventions.*** This program provides funds ($650,000) to redevelopment agencies that had bond debt tied to a previously provided personal property tax subvention. Redevel-

opment agencies use the funds in this item to offset their losses due to repeal of this subvention in 1984.

MANDATES

Figure 1 (see next page) summarizes the budget's proposal for the nine mandates under this item. For 2005-06, the administration proposes to (1) fund three of the mandates ($2.4 million) and (2) "suspend" the six other mandates. (When the state suspends a mandate for a fiscal year, it incurs no reimbursement liability for that year, and local governments are not required to provide the mandated services.)

Open Meeting Act

We withhold recommendation regarding this mandate pending release of the administration's proposal.

Background. In 1953, the Legislature enacted the Brown Act, declaring, "all meetings of the legislative body of a local agency shall be open and public, and all persons shall be permitted to attend any meeting of the legislative body." Because the Brown Act preceded the 1975 operative date of mandate law, its requirements are *not* a state-reimbursable mandate. Instead, the Open Meeting Act "mandate" pertains to certain post-1975 procedural amendments to the Brown Act, most notably the requirement that local agencies prepare and post agendas 72 hours before a hearing (Chapter 641, Statutes of 1986 [AB 2674, Connelly]). As Figure 1 indicates, based on prior-year claiming practices, we estimate that local agencies will claim $15.9 million for this mandate in 2005-06. (K-14 districts file separate claims.) Most of this amount reflects costs for agenda preparation and review. Many local agencies claim reimbursement for more than $1,000 per agenda prepared.

Budget Proposal. For 2005-06, the administration proposes to restructure the Open Meeting Act mandate and provide $2 million. At the time this analysis was prepared, no information regarding the administration's proposal was available. We estimate that, in its current form, the mandate would cost $15.9 million in 2005-06. In addition, it is our understanding of Proposition 1A that when the Legislature funds local agencies for 2005-06 costs, it must also fully reimburse local agencies for their 2004-05 costs. We estimate the 2004-05 state liability for this mandate is $15 million. The budget provides no funding for this purpose.

Recommendation. Pending release of the administration's proposal, we withhold recommendation regarding this mandate. We note, however, that California residents have shown longstanding interest in open hearings, and the state's voters recently enacted Proposition 59, amending the State Constitution to specify that meetings of public bodies and writings of public officials must be open to public scrutiny. Accordingly, legislative

Figure 1

State Mandates Under Item 9210

(Dollars in Thousands)

Mandate	LAO Estimates[a] 2004-05[b]	LAO Estimates[a] 2005-06	Budgeted 2005-06	LAO Recommendation
Open Meetings Act/ Brown Act Reform	$15,447	$15,910	$2,000	Withhold, pending proposal from administration.
Health Benefits for Survivors of Peace Officers and Firefighters	347	357	221	Fully fund at $703. Make future benefits subject to collective bargaining.
Rape Victim Counseling Center Notices	281	289	187	Delete funding. Modify to make requirement statement of legislative intent.
Photographic Record of Evidence	505	523	Suspend	Repeal mandate. If necessary, expand court authority.
Mandate Reimbursement Process	—[c]	—[c]	Suspend	Withhold, pending proposal.
CPR Pocket Masks	—[c]	—[c]	Suspend	Modify to make requirement statement of legislative intent.
Domestic Violence Information	—[c]	—[c]	Suspend	Modify to make requirement statement of legislative intent.
Filipino Employee Surveys	—[c]	—[c]	Suspend	Modify to make requirement statement of legislative intent.
Lis Pendens[d]	—[c]	—[c]	Suspend	Modify to make requirement statement of legislative intent.

[a] Based on existing law and claiming practices.

[b] Proposition 1A specifies that funding for a mandate's 2004-05 costs must be appropriated to continue a mandate in 2005-06.

[c] Costs unknown because mandate has been suspended for more than a decade.

[d] The administration indicates it will propose adding this mandate to the budget bill.

action to eliminate (or make optional) the *procedural elements* of the Open Meeting Act mandate would not likely reduce people's ability to monitor local agency actions. Accordingly, when considering the administration's Open Meeting Act mandate proposal, we recommend the Legislature consider as an alternative making the Open Meeting Act mandate optional (the Brown Act would still be in force). This alternative would eliminate all future state reimbursable costs for this mandate, as well as the requirement that the Legislature include funding for the mandate's 2004-05 costs in the 2005-06 budget.

Health Benefits for Survivors of Peace Officers and Firefighters

Given the requirements of Proposition 1A and past local agency claims, we estimate the cost of continuing this mandate in 2005-06 is $703,000, or $482,000 more than proposed. We recommend the Legislature augment the budget to fully fund the mandate, but enact legislation to eliminate the mandate on a prospective basis.

This mandate reimburses local agencies for the cost of providing health benefits to the survivors of firefighters and peace officers killed in the line of duty. Chapter 1120, Statutes of 1996 (AB 3478, Aguiar), and Chapter 193, Statutes of 1997 (SB 563, Brulte), require local governments to provide these benefits.

Two years ago, the Commission on State Mandates (CSM) estimated this mandate's annual costs would be about $150,000. Based on recent claims submitted to the State Controller's Office, however, the mandate's costs appear to be twice this amount because (1) health benefit costs are increasing and (2) local agencies request reimbursement for administrative costs as well as health benefit costs. For example, one-third of the City of Fullerton's most recent claim was for administrative costs.

Recommendation. In our view, the state should honor its commitment to *current* survivors of firefighters and peace officers. Accordingly, we recommend the Legislature increase the $221,000 proposed for this mandate by $482,000 to fully fund its 2005-06 and 2004-05 costs, as required by Proposition 1A. (The state would also incur out-year costs to continue these benefits for those survivors now receiving benefits.) In terms of *future* beneficiaries, however, we view payment of survivors' health benefits as an issue related to the terms of employment and working conditions. As such, the benefit is a matter for local collective bargaining. Accordingly, we recommend the Legislature enact legislation to eliminate, on a prospective basis, the state requirement to provide health benefits to survivors of local public safety personnel.

Rape Victim Counseling

We recommend the Legislature delete $187,000 for this mandate and enact legislation to specify that the mandate's provisions are expressions of legislative intent. To ensure that local agencies provide these services, the Legislature could adopt budget language making Citizens' Option for Public Safety funding contingent upon local law enforcement agency certification that it will carry out these responsibilities.

Under this mandate, local law enforcement agencies refer rape victims to local rape victim-counseling centers and provide victims with an information card regarding domestic violence. In their mandate claims, local agencies typically request reimbursement for (1) ten minutes of officer time, four minutes of clerical time, and two minutes of dispatch time per rape; (2) printing costs; and (3) administrative costs. While the budget proposes $187,000 for this mandate, we estimate the mandate's 2005-06 costs will be about $289,000 and its 2004-05 costs are about $281,000.

Recommendation. It should be standard practice for law enforcement agencies to refer rape victims to local victim-counseling centers and provide information regarding domestic violence. Given the mandate requirements of the California Constitution, however, placing this simple requirement into law shifts to the *state* all costs to carry out this local responsibility. State mandate costs, in turn, reduce resources available for state responsibilities. In our view, when an activity is a basic local government responsibility, the Legislature should modify the mandate to make it optional and consider alternative ways of encouraging specific local government actions. Accordingly, we recommend the Legislature modify this mandate in trailer bill language to specify that its provisions are expressions of legislative intent. Should the Legislature wish to ensure that local law enforcement agencies carry out these responsibilities, the Legislature could adopt budget bill language under this item, making receipt of COPS funding contingent upon agency certification that it will carry out these responsibilities. This alternative would eliminate state costs for the mandate in 2005-06 ($289,000), as well as the obligation to fund the mandate's 2004-05 costs in the budget year ($281,000).

Photographic Record of Evidence

We recommend that the Legislature enact trailer bill language to repeal this mandate and, if necessary, clarify or expand court authority to require substitutes for evidence that poses a health, safety, security, or storage problem.

As we describe more fully in *New Mandates: Analysis of Measures Requiring Reimbursement* (December 2003), this mandate requires local law enforcement agencies to provide photographs, chemical analyses, and other substitutes for evidence that a court determines poses a health, safety, security, or storage problem. In their mandate claims, local agencies typically request reimbursement for purchases of high-tech digital imaging and printing equipment. The administration proposes to suspend this mandate in the budget.

In our view, the responsibility for managing evidence used in the courts should rest with law enforcement agencies. The administration's proposal to suspend this mandate in the budget bill, however, raises two concerns. It could:

- ***Add Ambiguity to the Laws of Evidence.*** As we discuss in *An Assessment: Governor's Local Government Proposal* (May 2004), when a mandate is suspended, the suspension applies only to the sections of law (or laws) found to be a mandate by the CSM. All other provisions in the statute continue to have the force of law, but interpreting these remaining provisions (which may refer to the suspended provisions) can become very difficult. Because the Photographic Record of Evidence mandate pertains to an area of law where ambiguity could have serious consequences, we recommend the Legislature carefully craft permanent changes to the mandate's underlying statute, rather than using the suspension process.
- ***Increase in Court Costs.*** In 1985, court concerns regarding evidence storage and handling costs prompted passage of the subject legislation. At the time this analysis was prepared, we were not able to determine whether courts currently have sufficient authority—independent of this mandate legislation—to require local agencies to submit substitute evidence. If this mandate's suspension were to result in local agencies submitting some evidence that they currently do not submit, courts could experience increased storage and handling costs.

In light of these concerns, we recommend the Legislature reject the administration's proposal to suspend the mandate. Instead, we recommend that the Legislature enact trailer bill language to repeal this mandate and, if necessary, enact provisions clarifying or expanding the court's authority to require substitute evidence.

Mandate Reimbursement Process

We withhold recommendation on this mandate, pending development of a proposal to replace the existing mandate reimbursement process with a simpler one.

This mandate reimburses local agencies for their administrative costs to file mandate test claims and reimbursement claims. Typically, local agencies request reimbursement for their costs to (1) contract with mandate consulting firms and (2) oversee their consultants' contracts. The administration proposes to suspend this mandate in 2005-06. As a result, local agency actions to file test claims or reimbursement claims would be "optional." That is, local agencies would not be required to follow the mandate reimbursement process. However, by not following the process, local agencies would not receive state reimbursements of mandated local costs (as promised under the State Constitution).

There are problems with this reimbursement process mandate. First, it is expensive. Many local agencies' claims for their administrative filing costs equal or exceed 15 percent of their total claims. In large part, local agencies face little incentive to minimize mandate claim preparation or test claim filing costs. Instead, local agencies hire firms that specialize in the arcane mandate process and advertise that they can "maximize" local revenues from state reimbursements. Second, the existence of this reimbursable mandate reduces local agency (and their consultants') incentives to work with the state to develop an alternative, simpler mandate claiming system.

Despite these shortcomings, we cannot concur with the administration's proposal to suspend this mandate. Simply put, the mandate process is a product of state laws and regulations. If the administration finds the existing process objectionable, it is incumbent on it to suggest an alternative method of addressing these costs. The Legislature could assist in this by directing the administration, local agencies, and legislative staff to work together this spring to develop a new and simpler system for reviewing test claims and providing mandate reimbursements. This system should address the fundamental problems inherent in the existing system, which we outline in *The 2004-05 Budget: Perspectives and Issues* (please see page 197). Pending development of the new system, we withhold recommendation regarding this mandate.

Four Mandates Suspended Annually Since Early 1990s

The Legislature should recast as statements of legislative intent these long-suspended mandates.

The budget proposes to suspend the last four mandates shown in Figure 1. These four mandates impose minor local government requirements, such as a duty to report on the number of Filipino employees. Over the last decade, no funding has been proposed for these mandates by an administration or a legislative budget committee. Instead, these mandates have been routinely suspended. To clarify the requirements of state law, we recommend the Legislature enact trailer bill language recasting these provisions as statements of legislative intent.

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 (PERS), 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 $861 million General Fund request for annuitant benefits pending final determination of health insurance premium rates for calendar year 2006.

The budget proposes total expenditures of $861 million from the General Fund for health and dental benefits for annuitants in 2005-06. This is $65 million, or 8.2 percent, more than estimated expenditures for this purpose in the current year. This increase reflects continued enrollment growth of 3.5 percent, with the remaining increase of approximately 5 percent for health cost inflation. For 2005, health insurance costs grew more slowly than in recent years for the state's basic plans and declined for the state's Medicare supplement plans.

Figure 1 displays General Fund expenditures for annuitant health and dental benefits for the three fiscal years starting with 2003-04. Although these costs initially are paid from the General Fund, the state recovers a portion of these costs (about 33 percent) from special funds through pro rata charges.

Figure 1

Health and Dental Benefits for Annuitants

(Dollars in Millions)

Program	2003-04 Actual	2004-05 Estimated	2005-06 Budgeted	Change From 2004-05 Amount	Change From 2004-05 Percent
Health	$641.6	$738.7	$801.8	$63.1	8.5%
Dental	52.9	56.8	58.9	2.1	3.7
Totals	**$694.5**	**$795.5**	**$860.7**	**$65.2**	**8.2%**

Federal Subsidy for Prescription Drugs Will Offset State Costs. The amount proposed in this item includes an offsetting half-year savings of $35 million for the Medicare Part D prescription drug program that becomes effective on January 1, 2006. For employers (including the state) providing drug coverage that is at least equivalent to the Part D benefit, the federal government will subsidize a portion of prescription costs. The federal government currently estimates the value of this subsidy at $611 per Medicare enrollee in 2006.

Amount Needed Depends on Negotiations With Providers. The actual amount of funding needed in the budget year is dependent on negotiations over health insurance premiums currently underway between PERS and providers. These negotiated premium rates, which will cover the 2006 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.

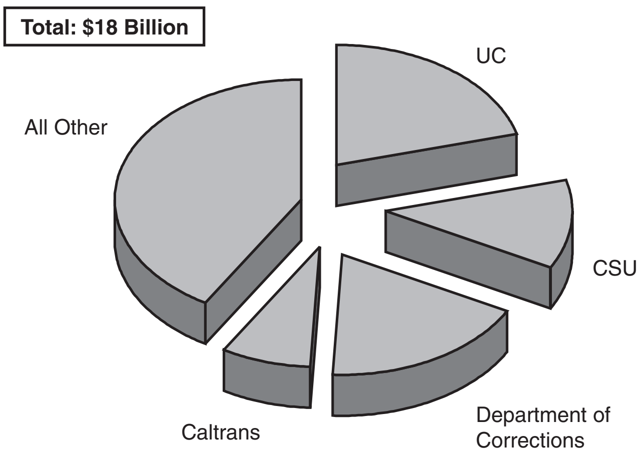
EMPLOYEE COMPENSATION
(9800/9955)

A significant portion of state government's operating costs is for compensation of state employees. Figure 1 displays a breakdown of 2004-05 estimated state payroll (excluding benefits expenditures for items such as health insurance and retirement), which totals $18 billion. As shown in the figure, higher education (consisting of the University of California [UC] and California State University [CSU] systems) represents one-third of state employment costs. The Departments of Corrections and Transportation combined represent an additional one-quarter of state payroll.

Figure 1

Estimated State Payroll

2004-05



The Governor's budget projects $19 billion in salary and wage expenditures for 327,000 authorized personnel-years (PYs) in 2005-06 (including $6.1 billion and more than 114,000 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 exceed $24 billion for the budget year, about one-half of which is supported from the General Fund.

Most State Employees Received Delayed 5 Percent Salary Increase. In the current year, most state employees received a 5 percent salary increase delayed from 2003-04, pursuant to renegotiated contracts. As shown in Figure 2, most bargaining units now have expired contracts or agreements

Figure 2

Status of Memoranda of Understanding (MOUs)

Unit Number	Bargaining Unit
MOUs Continuing Past June 30, 2005	
5	Highway Patrol
6	Corrections
8	California Department of Forestry Firefighter
9	Professional Engineers
10	Professional Scientific
16	Physician, Dentist, and Podiatrist
19	Health and Social Services/Professional
MOUs Expiring on June 30, 2005	
1	Professional, Administrative, Financial, and Staff Services
4	Office and Allied
11	Engineering and Scientific Technician
14	Printing Trades
15	Allied Services
20	Medical and Social Services
21	Educational Consultant and Library
MOUs Currently Expired	
2	Attorneys and Hearing Officers
3	Education and Library
7	Protective Services and Public Safety
12	Craft and Maintenance
13	Stationary Engineer
17	Registered Nurse
18	Psychiatric Technician

that will expire at the end of the current year. As a result, they will be negotiating with the state for new contracts.

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

Figure 3

State Civil Service General Salary Increases

1991-92 Through 2005-06

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]	2.2	1.9
2004-05[b]	5.0[c]	2.8	3.3
2005-06[b]	—[c]	1.9	2.5

a 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.

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

c Correctional officers will receive increases of 10 percent in 2004-05 and 5.1 percent in 2005-06 (with an additional 0.9 percent at the end of 2005-06). Highway patrol officers will receive an 11.8 percent increase in 2004-05 and 7.2 percent in 2005-06. Caltrans and other engineers will receive an estimated 4.8 percent increase in 2005-06.

Employee Pay and Benefit Increases—Item 9800

The budget includes $261 million ($198 million General Fund) for pay and benefit increases for (1) collective bargaining units with previously agreed upon provisions and (2) statutory dental and vision insurance increases. The budget does not include $150 million ($39 million General Fund) for salary and health insurance provisions that are scheduled to become effective in 2005-06.

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 (DOF) allocates to department budgets, from the lump-sum appropriation, the amounts necessary to fund these additional cost items.

The budget proposes $261 million ($198 million General Fund) for negotiated compensation packages. (This excludes higher education.) This amount includes $217 million ($145 million General Fund) for the third year of raises for highway patrol and correctional officers (Unit 5 and Unit 6, respectively) and annualized costs from their current-year salary increases (described below).

Multiyear Raises for Highway Patrol and Correctional Officers. The agreements for highway patrol and correctional officers include four annual pay raises, the third of which is effective July 1, 2005. The budget-year salary increases are currently estimated to be 7.2 percent and 5.1 percent, respectively. These amounts are based on pay levels of local law enforcement and could change depending on future local pay increases. Supervisors and managers of these employees will receive a similar package.

Figure 4 (see next page) shows the projected ongoing cost of the negotiated general salary increases for all employees from 2003-04 through 2006-07, when all pay raises already agreed to in the last complete bargaining cycle would be fully implemented. As shown in the figure, a key factor driving the growing costs is the multiyear, formula-based raises negotiated for the highway patrol and correctional officers. Total costs were $245 million in 2003-04 and will grow to an annual cost of $1.4 billion by 2006-07. More than one-half of these costs is to be paid by the General Fund.

Some Items Funded in Department Budgets. Item 9800 excludes the full-year cost of the deferred pay raises that went into effect after the beginning of the current year. In previous years, *all* new employee compensation costs (even for provisions already in effect for part of the current year) were first appropriated in this budget item. The DOF, however, included these full-year costs in departments' budgets for 2005-06 rather than reflecting them here. According to data from the Department of Personnel Administration (DPA), the 2005-06 cost to annualize current-year pay raises is an additional $60 million ($17 million General Fund) that is included in departmental budgets.

Figure 4

Costs of Negotiated General Salary Increases Above 2002-03 Costs[a] All Funds

(In Millions)

	2003-04	2004-05	2005-06	2006-07
Unit 5	$16	$87	$157	$193
Unit 6	119	332	529	664
All other	110	475	553	553
Totals	**$245**	**$894**	**$1,239**	**$1,410**

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

Some Items Not Funded. Item 9800 also does not include funding for two items that, pursuant to current agreements, have 2005-06 costs:

- ***Engineers Contract.*** Like highway patrol and correctional officers, the contract for Unit 9, which consists primarily of Caltrans engineers, includes annual formula-based pay raises designed to eliminate their pay differential with local government and UC engineers. This formula is supposed to become effective in 2005-06; however, the Governor's budget currently provides no funding for this item. The DOF is awaiting updated salary survey data to budget the appropriate amount. A previous survey estimated a 4.8 percent increase, which would amount to an additional $48 million ($1.8 million General Fund) in 2005-06.

- ***Health Insurance Premiums.*** For bargaining units that deferred the 2003-04 pay raise, the administration has not budgeted the cost of increases in state health insurance premiums to maintain 80 percent pick-up of total costs, as negotiated. This is because the administration intends to negotiate a reduction in state health insurance costs beginning in 2005-06 (see below). If this is not successful, however, the additional cost to the state to maintain the formula would be $102 million ($37 million General Fund), according to DPA data.

Proposed Savings From Collective Bargaining—Item 9955

The budget assumes $741 million ($408 million General Fund) in employee compensation savings to be achieved through collective bargaining. These amounts do not reflect the offsetting cost of any benefits the administration might agree to provide to unions in order to secure the proposed changes. As a result, the Legislature will want to weigh the value of any savings with the cost of concessions granted to achieve them.

The administration includes a new budget component, Item 9955, for employee compensation changes it intends to seek in collective bargaining. These items would be negotiated in new contracts when current agreements expire. The most significant proposals relate to retirement. (The Governor also has a "defined contribution" retirement proposal that we discuss in "Part V" of the *2005-06 Budget: Perspectives and Issues*.) The budget proposes $741 million ($408 million General Fund) in savings from these items. This amount includes:

- ***50/50 Split of Retirement Contributions—$374 Million ($206 Million General Fund).*** Instead of fixed employee contributions, the state would split annual, variable contributions (employee plus employer share) to the Public Employees' Retirement System (PERS) with employees. For 2005-06, this would increase a miscellaneous employee's retirement contribution from 5 percent to approximately 11 percent. This amount would vary from year to year, depending on fluctuations in the contribution rates determined by PERS.
- ***Opt Out of PERS for a Pay Raise—$164 Million ($90 Million General Fund).*** For nonsafety employees who do not want to pay higher retirement contributions, they could instead opt out of PERS for future service (past service would not be affected). In return, they would receive a pay raise of half the ongoing, annual state cost (the "normal cost") of the retirement benefit. For 2005-06, this would amount to approximately 5 percent for a miscellaneous employee. In addition, employees would increase their take-home pay by keeping the funds they previously contributed for retirement. Because of Social Security legal issues, the administration would not offer this option to safety employees.
- ***Furlough—$109 Million ($60 Million General Fund).*** The Governor would have the authority to furlough state employees (excluding public safety and around-the-clock staff) for up to five workdays a year to generate savings during a fiscal crisis. The budget assumes the Governor exercises this authority for the full five days to achieve these savings in the budget year.

- ***Health Benefits—$55 Million ($30 Million General Fund).*** To reduce the cost of health benefits: (1) state employees who are retired from the military would be enrolled in a federal health insurance program, (2) new employees could enroll in the state program after a six-month probationary period (instead of after the first month, as is current practice), and (3) the state would reduce its contribution for health insurance by approximately $14 per month on average.
- ***Overtime Change—$36 Million ($20 Million General Fund).*** Currently, time off for sick leave and vacation count as time worked when determining overtime eligibility during a given work period. This change would end the practice.
- ***Eliminate Two Holidays—$3.1 Million ($1.7 Million General Fund).*** Employees would lose two holidays, leaving 12 remaining.

Concessions Would Reduce Savings. The identified savings do not account for any offsetting benefits the state might agree to provide to unions in order to secure these changes in collective bargaining agreements. The cost of any such benefits would offset the savings achieved from the proposed changes. As a result, when considering agreements for approval, the Legislature will want to weigh the value of any savings achieved with the cost of concessions granted to achieve them.

RETIREMENT CONTRIBUTIONS (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 Up Slightly . . .

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 $2.5 billion to $2.7 billion in the budget year. This includes General Fund costs of $1.5 billion, an increase of $65 million. The final determination of 2005-06 contribution rates will occur in the spring. Figure 1 (see next page) shows these rates by classification since 1991-92.

Less-Than-Assumed Investment Performance Leads to Rate Increases. This continued growth in state retirement contributions to PERS primarily is caused by a string of less-than-assumed investment returns. Although investments earned nearly 17 percent in 2003-04, PERS still is recognizing previous losses in current retirement contribution rates through its actuarial smoothing process. The PERS's investment returns totaled just 4 percent for 2002-03. This followed a 6 percent loss for 2001-02 and a 7 percent loss for 2000-01, due primarily to the poor performance of the stock market in those years. By contrast, PERS assumes an 8 percent annual return over the long term for actuarial purposes.

Figure 1

State Retirement Contribution Rates

1991-92 Through 2005-06

Fiscal Year	Misc. Tier 1	Misc. Tier 2	Industrial	Safety	Peace Officer/ Firefighter	Highway Patrol
1991-92	11.8%	4.0%	13.4%	17.4%	17.4%	21.7%
1992-93	10.3	3.4	12.0	15.7	15.6	17.1
1993-94	9.9	5.0	11.8	15.5	15.2	16.9
1994-95	9.9	5.9	10.6	13.9	12.8	15.6
1995-96	12.4	8.3	9.0	14.2	14.4	14.8
1996-97	13.1	9.3	9.3	14.7	15.4	15.9
1997-98	12.7	9.8	9.0	13.8	15.3	15.5
1998-99	8.5	6.4	4.6	9.4	9.6	13.5
1999-00	1.5	—	—	7.5	—	17.3
2000-01	—	—	—	6.8	2.7	13.7
2001-02	4.2	—	0.4	12.9	9.6	16.9
2002-03	7.4	2.8	2.9	17.1	13.9	23.1
2003-04	14.8	10.3	11.1	21.9	20.3	32.7
2004-05	17.0	13.2	16.4	20.8	23.8	33.4
2005-06[a]	17.1	13.3	16.9	21.2	24.7	33.1

[a] Public Employees' Retirement System estimates.

. . . But Delayed Pension Bond Would Reduce 2005-06 Contributions

We withhold recommendation on 2005-06 state contribution rates for retirement benefits pending final determination of budget-year rates.

The current-year budget approved the borrowing of funds to pay a portion of state retirement contributions through a pension obligation bond. The bond has not been issued, as it has been challenged in court for the second year in a row. Previously, a Superior Court invalidated state issuance of a pension obligation bond in 2003-04 because the bond lacked voter approval.

Because of the delay, the administration plans to issue the pension obligation bond approved for the current year in 2005-06 instead (pursuant to the multiyear authority granted in the current-year budget package). As a result, the state would pay $1.9 billion in retirement contributions to PERS from operating funds in 2005-06, realizing savings of $765 million in the budget year. All of these savings would accrue to the General Fund.

The administration has counted these savings as part of its overall budget solution.

Pending final determination of 2005-06 rates, we withhold recommendation on this item.

PROCUREMENT REFORM
(CONTROL SECTION 33.50)

This control section allows the Department of Finance (DOF) to reduce departmental appropriations due to savings achieved from the Department of General Services' (DGS) "strategic sourcing" initiative. Strategic sourcing involves using past years' purchasing information and standard procurement methods to create new contracts for those same goods and services. The new contracts should result in lower costs.

This section was first included in the 2004-05 budget. At the time of 2004-05 budget's enactment, Control Section 33.50 was expected to achieve $96 million in current-year General Fund savings not accounted for elsewhere in the budget. The administration since has reduced its estimate of achievable General Fund savings this year to $48 million. The budget proposes ongoing General Fund savings of $96 million. This section provides the administration with authority to capture those savings from departments' budgets in 2005-06.

Minimal Contract Savings Achieved to Date

Since the Department of General Services (DGS) has only renegotiated one contract with an estimated savings of $3 million (all funds) and less than five months remain in the current year, it is unlikely that the administration will reach its estimate of $48 million in General Fund savings in the current year. For this reason, we recommend that the Legislature direct the Department of Finance (DOF) to revise the strategic sourcing savings estimates for both the current and budget years to be more realistic based on DGS' contracting experiences to date. In order to ensure that the Legislature has the opportunity to verify the savings, we also recommend that the control section be modified to include 30-day notification prior to DOF reducing appropriations.

Similar to the current language, the proposed Control Section 33.50 of the *2005-06 Budget Act* would allow DOF to reduce appropriations due to savings achieved through DGS' strategic sourcing efforts. Unlike the current language, however, this proposed budget does not require DOF to report to the Legislature on the proposed savings prior to reducing appropriations.

Strategic Sourcing Contract. In June 2004, DGS signed a contract with American Management Systems (AMS) to provide strategic sourcing services. Specifically, under the contract, the vendor reviews the state's annual goods and services expenditures and identifies those expenditure areas where new contracts (based on competition or negotiation) would result in future savings. In addition, the contractor assists the state in creating these new contracts. Once new contract savings are achieved, the contractor will receive a percentage of the accrued savings. For example, under the contract's current payment structure, if the state accrues savings of $100 million by 2007, the contractor will receive payments totaling $11 million. The percentage of savings paid to the vendor declines as the total savings increase. According to DGS, the contractor has not yet received any payments.

DOF Reduced Appropriations. In the summer of 2004, AMS identified several potential goods and services categories in which the state could save $100 million in 2004-05 by using strategic sourcing techniques. In September 2004, DOF notified the Legislature that it would reduce 19 departments' General Fund appropriations by $78 million. According to DOF, if the savings are not achieved, then the funds will be returned to the departments.

Minimal Savings Achieved to Date. According to DGS, since signing the AMS contract in June 2004, the state has renegotiated one contract resulting in an estimated current-year savings of $3 million (all funds). The DGS anticipates it will enter into an additional eight contracts within the current year. The savings from these additional contracts is unknown at this time. In January 2005, DOF returned $30 million to the 19 departments to reflect lower expected savings.

Direct DOF to Revise Estimated Savings. Given that the state to date has only signed one contract with an estimated savings of $3 million and less than five months remain in the current year, it is unlikely that the administration will reach its estimate of $48 million in General Fund savings this year. Moreover, the expected budget-year savings are unlikely to be achieved. Consequently, we recommend that the Legislature direct DOF to revise the strategic sourcing savings estimates for both the current and budget years to be more realistic based on DGS' strategic sourcing and contracting experiences to date. In order to ensure that the Legislature has the opportunity to verify the savings, we also recommend that the control section be modified to include 30-day notification to the Legislature prior to DOF reducing appropriations.

FINDINGS AND RECOMMENDATIONS

General Government

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Crosscutting Issues

Homeland Security

F-13 ■ **Homeland Security.** Only 31 percent of the state's homeland security funds have been spent. Recommend a number of actions to address problems on low expenditure rates for federal grants and the lack of information on the state's homeland security activities.

Department of Insurance

F-27 ■ **Insurance Fund Precariously Balanced.** The department's expenditures have generally outpaced revenues in the last several years. As a result, the Insurance Fund is projected to end the budget year with a 7 percent balance—less than one month's expenditures. To reduce personal services costs in the current year, the department has instituted a hiring slowdown.

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F-29 ■ **Recommend Rejecting Nonessential Proposals. Reduce Item 0845-001-0217 by $2.8 Million.** Recommend that the Legislature delete $2.8 million and three positions for nonessential proposals due to the condition of the Insurance Fund.

F-30 ■ **Online Credit Card Payment Efficiencies Should Be Reverted. Reduce Item 0845-001-0217 by $200,000.** Recommend that the Legislature delete $200,000 requested for credit card charges because licensing efficiencies from online filing fully offset this cost.

California Gambling Control Commission

F-31 ■ **Expansion of Commission Lacks Detail and Needs Further Consideration. Reduce Item 0855-001-0367 by $4,682,000 and Item 0855-001-0567 by $124,000.** Recommend that the Legislature reject the $4.8 million proposal to double the size of the commission. Administration should resubmit a request for resources that distinguishes between workload under the 1999 and 2004 compacts, provides justification for a state testing lab, and considers the role of the Department of Justice.

Board of Equalization

F-36 ■ **Electronic Remittance and Return Processing.** We recommend that the Board of Equalization (BOE) report at budget hearings regarding the status of efforts to convert existing paper tax filings and manual processing to electronic systems.

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F-38 ■ **Electronic Waste Recycling Fee.** We withhold recommendation on the budget augmentation for administering the Electronic Waste Recycling Fee pending the receipt of additional information from the BOE.

Secretary of State

F-40 ■ **Spending on Federal Election Reform Will Depend on Current-Year Actions**. Implementation of the Help America Vote Act represents a significant opportunity for the Legislature to upgrade the state's election systems and improve the administration of election laws. Withhold recommendation on spending pending the receipt of a proposal from the administration.

F-48 ■ **Governor Proposes to Suspend All Election Mandates.** Proposal could cause confusion regarding which election procedures are required and optional for counties. Recommend repealing two mandates which no longer require any substantial activities. Recommend funding two mandates with minimal state costs in order to maintain legislative policy. Reform the reimbursement methodology and fund three mandates in order to maintain statewide uniformity.

California Science Center

F-56 ■ **Admission Fee Information Not Provided.** Withhold recommendation on the department's proposed General Fund budget pending receipt and review of the

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department's report on options for charging an admission fee.

Franchise Tax Board (FTB)

F-59 ■ **Electronic Return and Remittance Processing. Reduce Item 1730-001-0001 by $800,000.** Recommend that the Legislature reduce FTB's budget to account for savings associated with the increase in electronic return and remittance processing and the reduction in the number of paper submissions.

F-60 ■ **Adjust Salaries for Auditors. Reduce Item 1730-001-0001 by $200,000.** Recommend the Legislature reduce FTB's budget to account for reduced salaries for entry-level auditors to work on tax gap related audits.

Department of General Services

F-61 ■ **Modify Budget Provisions.** Modify budget provisions 3 and 4 of Item 1760-001-0666 to clarify legislative intent on authorized expenditure authority adjustments.

F-63 ■ **Drug Procurements.** Recommend Department of General Services submit a budget proposal to implement recommendations to correct deficiencies in its drug procurement operations.

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State Personnel Board

F-64 ■ **POBOR Mandate.** Recommend the Legislature request the Commission on State Mandates to reconsider its decision regarding the Peace Officer Procedural Bill of Rights mandate.

State Teachers' Retirement System

F-67 ■ **Short Term: Does the Governor's Proposal Work as a 2005-06 Budget Solution?** We find that the Governor's proposal to shift the state benefits contribution to school districts likely would not achieve the intended savings under current law.

F-74 ■ **Long Term: Does the Proposal Move Toward the Goals of Local Control and Responsibility?** The Governor's proposal would not fundamentally reform the State Teachers' Retirement System. To move towards a retirement system that emphasizes local control and responsibility, the Legislature would need to focus on a new approach for new teachers.

Department of Technology Services

F-76 ■ **Create Department of Technology Services (DTS). Amend Budget Bill to Include $235 Million Appropriation in a DTS Revolving Fund.** Approve data center consolidation consistent with previous legislative direction, but amend proposal in various ways to improve legislative oversight.

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F-82 ■ **DTS Staff Increase. Reduce DTS Revolving Fund by $266,000.** Reject request for three additional positions and $266,000 since the administration has not completed a position review of the consolidated data center.

Department of Corporations

F-83 ■ **Grant Funding for Investment Fraud Education Comes to an End. Reduce Item 2180-001-0067 by $400,000.** Recommend that the Legislature delete $400,000 to continue an investment fraud education program previously supported with grant funds because of questionable benefits and other existing programs.

F-84 ■ **Online Filing Program Double-Budgets Some Equipment Replacement. Reduce Item 2180-001-0067 by $40,000.** Recommend that the Legislature reduce the request by $40,000 to account for the double-budgeting of server replacement.

Employment Development Department (EDD)

F-86 ■ **Update on the UI Insolvency.** Recent economic growth and the corresponding modest increase in employment have substantially reduced the projected deficit in the Unemployment Insurance (UI) fund. We review the UI fund condition, the status of the state's federal loan, and the need for legislative action.

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F-90 ■ **Improving Legislative Oversight for Unspent WIA Funds.** Recommend strengthening budget control language pertaining to unexpended Workforce Investment Act (WIA) funds from prior years because state WIA discretionary funds may be used for many purposes.

F-92 ■ **Restoring Auditors and Collectors to Increase Revenue.** Recommend adding 50 auditor and collector positions to EDD for the purpose of collecting an additional $6 million in General Fund revenues, $2.2 million in UI fund revenues, and $1.2 million in special fund revenues. This proposal provides a net benefit of $3.4 million to the General Fund. Further recommend supplemental report language requiring EDD to report on the increased revenues from this proposal.

California Department of Food and Agriculture

F-94 ■ **Funding Options for the Mediterranean Fruit Fly.** To the extent that the Legislature chooses to assess a fee to cover the state's share of costs of the Medfly Preventative Release Program, we offer a number of considerations concerning a fee structure.

F-98 ■ **Position Information Not Available.** Withhold recommendation on the department's proposed Agriculture Fund budget of $116 million and 484 positions pending receipt of a complete report required regarding the fund's positions. The report submitted by the department did not include most of the required information.

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F-99 ■ **Animal Control Mandate.** Recommend that the Legislature revise the parameters and guidelines of the mandate to lower its costs.

F-101 ■ **Emerging Threats to Food Supply. Reduce Item 8570-001-0001 by $2.7 Million.** Recommend the deletion of $2.7 million in General Fund support proposed for resources related to threats to the food supply. Instead, we recommend the administration resubmit a request that reflects a coordinated effort with the state's two primary homeland security departments.

Military Department

F-103 ■ **Oakland Military Institute. Reduce Item 8940-001-0001 by $1.3 Million.** Reject proposed increase in institute funding because the school has been able to operate and expand its program with reduced Military Department personnel.

Tax Relief

F-106 ■ **Senior Citizens' Property Tax Deferral Program.** We recommend that the Legislature direct the administration to document likely participation in the Senior Citizens' Property Tax Deferral Program.

F-108 ■ **County Auditor Redevelopment Tax Report Mandate.** We recommend that the Legislature eliminate the mandate requiring county auditors to prepare a report on redevelopment tax increment revenues.

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Local Government Financing

F-111 ■ **Open Meeting Act Mandate.** Withhold recommendation, pending receipt of administration's proposal.

F-113 ■ **Health Benefits for Survivors of Peace Officers and Firefighters. Increase Item 9210-295-0001 (5) by $482,000 to Fully Fund the Mandate's 2005-06 and 2004-05 Costs.** Enact trailer bill legislation modifying the mandate prospectively to make benefits subject to the collective bargaining

F-114 ■ **Rape Victim Counseling. Delete Item 9210-295-0001 (3) for a Savings of $187,000.** Enact trailer bill language modifying mandate to make it a statement of legislative intent.

F-114 ■ **Photographic Record of Evidence. Delete Item 9210-295-0001 (4).** Enact trailer bill language eliminating mandate and, if needed, increasing or clarifying court authority to require substitute evidence.

F-115 ■ **Mandate Reimbursement Process.** Withhold recommendation pending development of new proposal.

F-116 ■ **Four Mandates Suspended Annually Since Early 1990s. Delete Items 9210-295-0001 (6-8).** Enact legislation modifying mandate to make it a statement of legislative intent.

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Health and Dental Benefits for Annuitants

F-118 ■ **Budget-Year Costs Not Yet Completely Determined.** Withhold recommendation on the $861 million General Fund request for annuitant benefits pending final determination of health insurance premium rates for calendar year 2006.

Employee Compensation

F-123 ■ **Employee Pay and Benefit Increases—Item 9800.** The budget includes $261 million ($198 million General Fund) for pay and benefit increases for (1) collective bargaining units with previously agreed upon provisions and (2) statutory dental and vision insurance increases. The budget does not include $150 million ($39 million General Fund) for salary and health insurance provisions that are scheduled to become effective in 2005-06.

F-125 ■ **Proposed Savings From Collective Bargaining—Item 9955.** The budget assumes $741 million ($408 million General Fund) in employee compensation savings to be achieved through collective bargaining. These amounts do not reflect the offsetting cost of any benefits the administration might agree to provide to unions in order to secure the proposed changes. As a result, the Legislature will want to weigh the value of any savings with the cost of concessions granted to achieve them.

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Retirement Contributions

F-128 ■ **Delayed Pension Bond Would Reduce 2005-06 Contributions.** Withhold recommendation on 2005-06 state contribution rates for retirement benefits pending final determination of budget-year rates.

Procurement Reform

F-130 ■ **Contract Savings Overstated.** Direct the Department of Finance (DOF) to revise the strategic sourcing savings estimates for both the current and budget years to be more realistic. Modify proposal to include 30-day notification to the Legislature prior to DOF reducing appropriations.