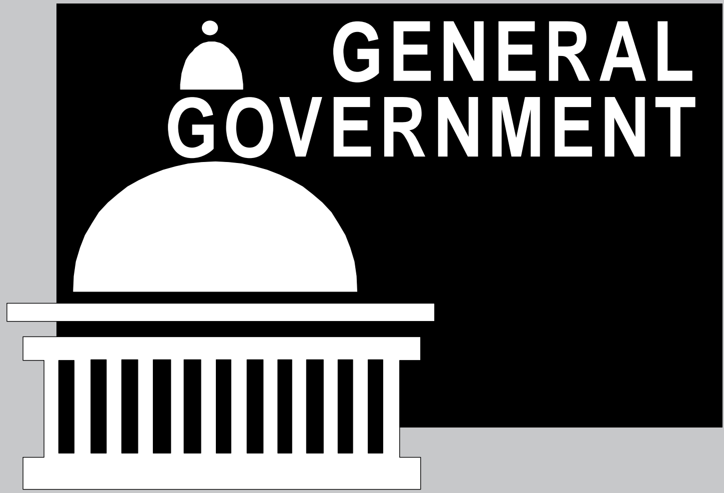

2003-04 Analysis

MAJOR ISSUES

General Government

Incurring Debt for Retirement Costs Is Ill-Advised

- To reduce budget costs, the administration proposes to finance up to $2.5 billion in scheduled retirement contributions to the Public Employees' Retirement System and the State Teachers' Retirement System. The majority of these costs are for the ongoing operating expenses of the retirement systems.

- Incurring decades worth of debt to avoid an annual operating expense as a budget-balancing tool is poor fiscal policy. We recommend rejecting the administration's proposal (see page F-13).

Risky Assumption of $1.5 Billion, But Existing Gaming Revenue Can Help Budget Shortfall

- The budget assumes $1.5 billion in new revenues to the General Fund from the renegotiation of revenue sharing agreements with Indian tribes. The agreements are voluntary, and the proposed amount is ten times what tribes currently pay. The realization of such revenue, therefore, is unlikely.

- The administration does not propose a spending plan for $88 million in the Indian Gaming Special Distribution Fund. We recommend using these funds for gambling-related expenses currently paid by the General Fund, such as public safety and mental health funding for local governments (see page F-63).

911 Surcharge Increase Not Appropriate

- The budget proposes to increase a 911 emergency surcharge (assessed on phone bills) in order to generate $50 million in new revenues. The funds would be spent on various state activities currently funded primarily from the Motor Vehicle Account. Since it is inconsistent with the purpose of the surcharge, we recommend rejecting the proposal (see page F-25).

Effectiveness of Film Subsidies and Trade Offices in Doubt

- While making cuts in most other Technology, Trade, and Commerce Agency programs, the budget proposes to continue funding for a film permit subsidy program and the foreign trade offices. Both of these programs have questionable effectiveness. We recommend deleting the $12 million proposed for these programs (see page F-103).

Better Choices Than Deferring Mandates

- As with the 2002-03 budget, the administration proposes to defer the costs of all general government mandates on local governments. By the end of the budget year, the state would owe over $1.2 billion to noneducation local governments. Instead of this approach, we recommend the Legislature adopt the general policy of either funding its mandate obligations—or eliminating the state's liability for the mandate. We recommend that funding for some mandates be consolidated within the state-county realignment proposal and that all other mandates be repealed, modified, or suspended for the budget year (see page F-17).

- We review two mandates in detail. We recommend the Legislature (1) eliminate the regional planning mandate for cities and counties, as it does not ensure compliance with state housing requirements (see page F-95); and (2) refer more than $60 million in animal control claims to the Joint Legislative Audit Committee for review (see page F-133).

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OVERVIEW

General Government

Total state funding for general government is proposed to decrease by about 30 percent in the budget year. This sizable decrease is primarily due to the Governor's proposals to (1) reduce the vehicle license fee backfill to local governments and (2) borrow the funds to pay the state's retirement contributions. The budget also proposes spending reductions in many general government departments.

The "General Government" section of the budget contains a number of programs and departments with a wide range of responsibilities and functions. These programs and departments provide financial assistance to local governments, protect consumers, promote business development, provide services to state agencies, ensure fair employment practices, and collect revenue to fund state operations. The *2003-04 Governor's Budget* proposes $8.2 billion in state funds for these functions. The proposed budget-year funding is $3.5 billion (30 percent) less than estimated 2002-03 expenditures.

SPENDING BY MAJOR PROGRAM

There are six major program areas within general government:

- Local government subventions, which include shared revenues and local government financing.
- Tax relief.
- Tax collection programs.
- Regulatory programs.
- State administrative functions.
- State retirement and employment.

We describe these program areas below, and Figure 1 shows the estimated 2002-03 and proposed 2003-04 expenditures (combined General Fund and special funds) by program area.

Figure 1

General Government Spending by Program Area

2002-03 and 2003-04
(In Millions)

Agency/Program	Estimated 2002-03	Proposed 2003-04	Difference
Local government subventions	$2,640	$2,671	$31
Tax relief	3,240	1,614	-1,625
Tax collection	656	646	-10
Regulatory	2,564	2,339	-225
State administration	988	1,032	44
Retirement and employment	1,668	-57	-1,726
Totals	**$11,756**	**$8,244**	**-$3,511**

Totals may not add due to rounding.

Local Government Subventions

The local government subvention program—proposed to total $2.7 billion in 2003-04—(1) distributes state-collected revenue (primarily from the vehicle license fee [VLF] and gas tax) to local government agencies (referred to as "shared revenues") and (2) provides local governments additional funding for specified programs.

The Governor's budget proposes to subvene to local governments $2.4 billion in shared revenues (virtually all from special funds). This is approximately the same as the current-year funding level. Another $330 million in local assistance (all General Fund) is proposed for the Citizens' Option for Public Safety/juvenile justice programs ($233 million) and other local government programs.

Tax Relief

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 Governor's budget proposes approximately $1.6 billion for tax relief appropriations in 2003-04, representing a significant decrease from the estimated $3.2 billion in 2002-03. The decrease

is due to the proposed elimination of the VLF "backfill" to cities and counties of revenues lost when the VLF rate was reduced. This elimination is proposed to begin in February 2003, resulting in a savings of approximately $1.3 billion in the current year. As a result of this proposal, the only remaining backfill would be that related to the 1991 state-local realignment. The two largest tax relief components are the VLF realignment backfill ($987 million) and the homeowners' property tax exemption ($419 million) programs.

Tax Collection Programs

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 (PIT) and the corporation tax (CT). 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 (SUT), as well as excise taxes on fuel, cigarettes, and alcoholic beverages.

Expenditures. The budget proposes total funding of $602 million (General Fund) for these two agencies in 2003-04, down roughly $15 million (about 2 percent) from the current year. This includes General Fund support for FTB of $403 million, representing a decrease of about 4 percent from 2002-03. Proposed General Fund support for BOE is $199 million (approximately the same as the current-year funding level).

Estimated Tax Collections. The budget estimates that 2003-04 state tax collections will be approximately $43 billion for FTB and $36 billion for BOE—for a total of $79 billion. Roughly $64 billion of this amount represents General Fund revenues, including 53 percent from the PIT, 36 percent from the SUT, and 10 percent from the CT.

Regulatory Activities

A total of 20 departments are responsible for providing regulatory oversight of various consumer and business issues. 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 different occupations to large corporations licensed to conduct business in the state. Most of these departments are funded from special funds that receive revenues from regulatory and license fees. Included in this group are the Departments of Consumer Affairs, Industrial Relations, Food and Agri-

culture, Financial Institutions, Insurance, Corporations, and the California Public Utilities Commission (CPUC).

The budget proposes total state-funded expenditures of $2.3 billion to support activities by the regulatory agencies. This amount includes $170 million from the General Fund and almost $2.2 billion from special funds. The proposed expenditures are $225 million, or 9 percent, less than estimated current-year expenditures. The reduction is largely due to a drop of $215 million in CPUC expenditures attributable to the projected decline in use of services provided by several telecommunication programs.

State Administrative Functions

There are more than two dozen departments and agencies that provide a wide range of administrative services. These services range from oversight and support of other departments (Departments of Finance and General Services [DGS]) to economic development (Technology, Trade, and Commerce Agency [TTCA]) to various specialized services provided to individuals and communities (Office of Emergency Services, Military Department, and Department of Veterans Affairs).

The budget proposes $1 billion in state funds to support these functions in 2003-04. This is an increase of $44 million, or 4 percent, from current-year expenditures. The proposed increase is primarily due to increased housing bond expenditures by the Department of Housing and Community Development ($106 million)—offset by various spending reductions in TTCA ($29 million), DGS ($16 million), and the Arts Council ($8 million).

State Retirement Programs

The state contributes to the retirement systems for all state employees and public school teachers. Retirement-related expenditures account for a significant part of state spending on an annual basis. Contributions are made from the General Fund and various special funds. In 2003-04, proposed General Fund expenditures for public employee retirement-related costs (excluding University of California costs) will total $1.2 billion, as shown in Figure 2. As discussed below, this amount is significantly lower than the current-year level due to the Governor's retirement proposals.

The General Fund provides for employer contributions and/or various other payments to three retirement systems. In addition, the state (1) contributes to the payment of premiums for health and dental benefit plans for retired state employees and (2) makes Social Security and Medicare contributions for most state employees.

Figure 2

General Fund Costs for Retirement Programs[a]

(In Millions)

	Estimated 2002-03	Proposed 2003-04
State Retirement Plans		
State Teachers' Retirement	$976	$55
Public Employees' Retirement	654	—
Judges' Retirement	118	132
Defined Contribution Plans[b]	39	39
Subtotals	($1,787)	($226)
Other Retirement Benefits		
Health and Dental Benefits for Annuitants	$577	$660
Social Security and Medicare[c]	358	358
Subtotals	($935)	($1,018)
Totals	**$2,722**	**$1,244**

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.

Public Employees' Retirement System (PERS). The PERS is the retirement system for most state employees. As shown in Figure 2, the budget does not include any state retirement contributions for PERS in 2003-04. This is because the Governor proposes to borrow the funds to pay these costs through (1) pension obligation bonds or (2) a loan agreement with PERS. Either of these options would result in the state realizing savings of up to $2.1 billion ($1.1 billion General Fund) in the budget year. (Please see the discussion of the retirement proposal in the "Crosscutting Issues" section of this chapter.)

State Teachers' Retirement System (STRS). The STRS is the retirement system for teachers in public K-12 schools and community colleges. The STRS receives contributions from teachers and their employers. These contributions, however, have historically been insufficient to provide for the cost of basic retirement benefits (which were increased by 1998 and 2000 legislation), the protection of retirees' purchasing power, and past unfunded liabilities (the system no longer has an unfunded liability).

These remaining costs have been covered by annual payments from the General Fund. In the budget year, we estimate that these costs will total $1 billion.

As shown in Figure 2, the Governor's budget proposes a state payment of only $55 million. The Governor's mid-year proposal includes a reduction of the $555 million purchasing power protection payment by $500 million. In addition, as with PERS, the Governor's budget proposes payment of the $448 million basic benefits contribution through either pension obligation bonds or a loan from the pension system. This would generate equivalent General Fund savings for the budget year.

Health and Dental Premiums. The budget also includes $660 million from the General Fund to pay the state share of health and dental insurance premiums for retired state employees and their qualifying beneficiaries. This is $84 million more than estimated current-year expenditures, largely due to 2003 health insurance premium increases that topped 25 percent. The PERS is currently negotiating the health premium rates for the second half of the budget year. These negotiations may result in a change in the estimated General Fund cost for the budget year.

Employee Compensation

There are about 176,000 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 (MOU). Most bargaining units have MOUs that are effective through the start of the budget year. These agreements include a 5 percent salary increase effective on July 1, 2003. However, the California Highway Patrol and California Correctional Peace Officers Association have multiyear agreements that include the first of four annual salary increases in 2003-04.

The costs of these pay increases are not included in the budget. Instead, the Governor's budget proposes an $855 million reduction in employee compensation costs for 2003-04, including $470 million from the General Fund. This is roughly equivalent to an 8 percent salary cut. The Governor has directed the Department of Personnel Administration to negotiate provisions with the employee unions to achieve the identified savings through some combination of pay or benefit cuts, layoffs, or other measures.

CROSSCUTTING ISSUES

General Government

STATE RETIREMENT CONTRIBUTIONS

Background

The state makes annual contributions to the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS) to fund retirement benefits that will be paid out in the future. In 2003-04, the estimated state contribution to PERS is $2.1 billion ($1.1 billion General Fund). The General Fund provides the entire benefits contribution to STRS, which is estimated at $448 million in the budget year.

In certain past years, due to budget constraints, the state deferred payment of these retirement obligations. Subsequent court decisions, however, have strictly limited the state's ability to defer these contributions. In addition, Proposition 162, which was approved by voters in November 1992, gave PERS and STRS independent authority to administer the pension systems. Thus, any decision not to make scheduled annual retirement contributions necessitates substantial care regarding legal requirements.

Budget Proposal

The Governor's budget proposes two alternatives to the standard payment of the state's 2003-04 contributions to PERS and STRS: (1) issue pension obligation bonds or (2) borrow the necessary funds from the systems. The proposal aims to achieve General Fund savings in the budget year to help address the state's fiscal condition. At this point, the administration is pursuing the feasibility of both alternatives.

If the proposal applies solely to General Fund retirement contributions, the state would reduce budget-year expenditures by $1.5 billion. If the proposal includes the special fund contributions to PERS as well, the total expenditure reduction would be $2.5 billion.

Normal Cost Versus Unfunded Liability. The estimated $2.1 billion budget-year contribution to PERS consists of two components:

- The "normal cost" of $1.6 billion (three-quarters of the total), which is the cost of providing retirement benefits for current state service. This is approximately 12.2 percent of estimated 2003-04 payroll.
- The "unfunded liability" of $0.5 billion (one-quarter of the total), which is the difference between retirement benefit liabilities already incurred and existing pension funds. This is approximately 4.2 percent of estimated budget-year payroll.

The state contribution to STRS does not currently include an unfunded liability component.

First Alternative—Pension Obligation Bonds

The first alternative the administration proposes is the issuance of pension obligation bonds to pay the state's 2003-04 retirement contributions for PERS and STRS benefits. Under this alternative, the state would issue general obligation bonds, payable over 20 years.

Bonds Have Been Used to Pay Off Unfunded Liabilities. Normally, government agencies with unfunded liabilities pay off a portion of it in annual retirement contributions over a set period of time. This payment includes interest calculated at the pension system's assumed rate of return on its investments.

Since 1993, however, more than two dozen cities and counties in California have issued taxable pension obligation bonds to pay off, in a lump sum in today's dollars, their unfunded liabilities. The State of New Jersey has issued pension obligation bonds as well. These transactions in effect substitute payments to the pension system with payments to bondholders. The difference in interest charges between the pension system's higher assumed rate of return and bond payments can generate savings for the governmental entity.

Typically, general obligation bonds must be approved by the voters because they are backed by the full faith and credit of the issuing government. In proceedings regarding local governments, however, courts have held that pension obligation bonds constitute payment of an *existing* obligation rather than new indebtedness. In this case, the transaction ex-

changes one debt (the unfunded liability) for another (payments owed bondholders). Thus, the sale of pension obligation bonds does not apply to debt limit provisions, and voter approval is not required.

Governor's Proposal Departs From Standard Use. In our review of other governments' actions, we did not find an example where pension obligation bonds were used solely to pay for an annual retirement contribution, as the Governor proposes. In issuing pension obligation bonds to pay off their unfunded liabilities, some entities have included one or two years' worth of ongoing contributions for some budget relief. But retiring the unfunded liability has always been the driving factor—not relieving budget pressure by incurring debt to pay regular retirement contributions.

Does the General Obligation Bond Exception Apply to the State? It is our understanding that both the administration and the Attorney General believe the exception to voter approval that courts have held applies at the local level can legitimately be applied to the state as well. Yet the budget proposal is fundamentally different than previous pension obligation bonds, which have paid off unfunded liabilities. The state would primarily be financing its normal costs, rather than an existing debt. As a result, it is unclear to us if local government precedents would apply.

Special Funds Too? The administration has not determined whether to include the $980 million special fund retirement contributions to PERS in this alternative. (As noted above, the state's STRS contributions are entirely from the General Fund.) The Department of Finance (DOF) indicates that if this 2003-04 obligation were included, the special fund amounts could be transferred to the General Fund in the budget year to address the shortfall. This is because the General Fund would incur the future obligation to pay off the bonds.

Second Alternative—Fixed-Income Investment

Under the second alternative, the state would not pay its budget-year retirement contributions in 2003-04. Instead, the administration would enter loan agreements with PERS and STRS. The state's budget-year loans would become part of the systems' investment portfolios. The state would pay the amounts due over time, plus a fixed interest rate that would be lower than the pension systems' assumed rates of return—8.25 percent for PERS and 8 percent for STRS. The DOF has indicated that the administration would not pursue this alternative if PERS and STRS demanded additional retirement benefits in exchange for the loan agreement, due to the significant additional cost this would likely entail.

Details Not Ironed Out

At this point, the administration is still determining the viability of both alternatives. According to DOF, a working group consisting of representatives from DOF, PERS, STRS, the Attorney General, the State Treasurer, and the State Controller is meeting to determine the workability of the pension bond alternative and to attempt to iron out the details.

At the time of this analysis, DOF had not met with STRS on the loan option. In addition, PERS has indicated that this alternative is "off the table" for their consideration because (1) it raises tax-exemption issues for the pension fund's investments and (2) the administration is not proposing a retirement benefit enhancement in exchange for the loan.

Incurring Debt for Operating Costs Is Ill Advised

We recommend that the Legislature reject the administration's debt alternatives to pay 2003-04 state retirement contributions. Incurring years of debt to avoid an annual operating expense as a budget-balancing tool is poor fiscal policy.

As discussed above, we have not discovered an instance where pension obligation bonds have been used solely to pay annual retirement contributions—an ongoing operating expense. Rather, these bonds have been used to pay off a retirement system's unfunded liability—an obligation already incurred. Incurring decades worth of debt to avoid an annual operating expense as a budget-balancing tool is poor fiscal policy. Our conclusion also applies to the loan option, which would similarly obligate the state to several years' worth of payments with interest for the 2003-04 state retirement contributions. Consequently, we recommend that the Legislature reject these debt proposals.

State May Wish to Consider Bonds for Unfunded Liability. The state could consider issuing pension obligation bonds for some of the unfunded liability associated with PERS. For example, if the state issued bonds to pay the unfunded liability portion of its 2003-04 contribution ($0.5 billion), this obligation would no longer be charged through the PERS annual contribution rate. This would achieve one-time budget-year savings by reducing the 2003-04 state contribution by the same $0.5 billion.

GENERAL GOVERNMENT—MANDATES

We recommend the Legislature adopt the general policy of either funding its mandate obligations—or eliminating the state's liability for the mandate. We recommend that some mandates be consolidated with the state-county realignment proposal and that all other mandates be repealed, modified, or suspended for the budget year.

Background

The California Constitution requires the state to reimburse schools and other local agencies if it "mandates" a new program or higher level of service. Traditionally, the Legislature has funded ongoing mandates in the budget and "new" mandates (those recently identified by the Commission on State Mandates) in the annual claims bill. In addition, because funding in the budget act seldom has been sufficient to pay all local mandate claims, the Legislature usually appropriates funding for mandate deficiencies in the annual claims bill.

In 2002-03 due to the state's fiscal difficulties, the state did not fund noneducation mandates in the budget or claims bill, but deferred all mandate reimbursements to an unspecified date. (We discuss education mandates separately in the "Education" chapter of this *Analysis*.) Because the state did not repeal or suspend local governments' legal obligations, however, local agencies must carry out these mandated tasks despite the delay in reimbursement.

Budget Proposal

The budget proposes to continue deferring all general government mandate reimbursements in 2003-04. Given the requirements of the California Constitution and state law, these mandate deferrals essentially are a "loan" from local governments that the state eventually must repay with interest. We estimate that, by the end of the budget year, the state will owe California noneducation local agencies over $1.2 billion for mandate claims.

Given the state's fiscal difficulties, the administration's proposal to defer mandate reimbursements is not a wise strategy. Instead of allowing

the mandate loan from local governments to grow, the Legislature should act to reduce its mandate liability. Accordingly, we recommend that the Legislature adopt the policy of either funding a mandate—or eliminating the state's liability for the mandate. The Legislature can eliminate its liability for a mandate by:

- Repealing the mandate.
- Modifying the mandated requirement to make it optional, or to permit local governments to offset their costs through fees or program-related savings.
- Suspending the mandate for the budget year pursuant to Government Code Section 17581. (This places "on pause": (1) local government's requirement to perform the mandated activity and (2) the state's obligation to reimburse any costs.)

Currently, the state has fiscal responsibility for 59 ongoing general government mandates costing approximately $300 million annually, plus another 26 mandates that the state has suspended annually for a decade. Our review indicates that at least 13 of the ongoing mandates (seven mental health, three voting procedure, and three property tax administration mandates) could be consolidated and funded within the proposed state-county program realignment (see *Perspectives and Issues*, "Part V"). Such an action would provide counties with ongoing resources and eliminate the extensive paperwork associated with mandate claiming. Before including these mandates in state-county realignment, however, we recommend that the Legislature modify the underlying requirements of these 13 mandates to increase county flexibility and lower county compliance costs. The amount of realignment funding provided to counties should reflect these mandate changes.

While many of the 46 other ongoing general government mandates involve beneficial governmental procedures, we recommend that they be suspended or repealed in light of the state's fiscal difficulties. In addition, as we discuss later in this *Analysis*, we recommend that the Legislature modify the Regional Housing Needs Mandate and request the Bureau of State Audits to review Animal Control mandate claims.

In terms of the 26 mandates that have been suspended annually for a decade, we recommend that these mandates be permanently repealed. Most of these long-suspended measures impose relatively minor local government requirements—such as a duty to report on the number of Filipino employees—and their repeal would eliminate any potential confusion regarding local government obligations.

VACANT POSITIONS

Recently, the Legislature has taken various steps, through budget control sections, to reduce the number of vacant positions in state government. In our review, we found that the Department of Finance (DOF) has provided most of the information requested. In some cases, however, the submittal was incomplete. Consequently, we recommend that DOF provide updated information on the various control sections. We also recommend the deletion of Control Section 31.75 from the 2003-04 Budget Bill, as it is unnecessary.

The 2002-03 budget provided for the elimination throughout state government of 6,000 vacant positions in the current year and 1,000 additional positions in the budget year. Below, we update the status of this process and provide recommendations that ensure the requirements of the control sections are met.

Background

How the Problem Started. For many years, most state departments absorbed a number of costs without receiving corresponding changes to their budgets. These include (1) inflationary cost increases for operating expenses and equipment, (2) merit salary adjustments that departments must provide to eligible employees every year, and (3) "unallocated reductions" (where departmental budgets are reduced, but no accompanying changes are made to modify or reduce workload or program responsibilities). One strategy used by departments to cover such costs is to deliberately hold positions vacant in order to generate "salary savings."

Past Efforts to Address Vacancies and Underfunding. Responding to legislative concern over the number of vacancies in departments, the Department of Finance (DOF) has taken some steps in recent years to address the inflated vacancy rate and underfunding issues. For example, the administration reports that over 6,500 vacant positions were eliminated in 2000-01 and 2001-02. In addition, DOF has allowed departments to budget new positions at the midstep instead of the first step of classifi-

cations where appropriate. Previously, departments were provided funding for the lowest salary in a classification. If the department, therefore, filled the position at a higher salary, the department was underfunded for the position and had to generate savings elsewhere to make up the difference. Recently, the administration also has funded department costs for various salary adjustments resulting from collective bargaining agreements.

These steps should have reduced pressure on some departments to leave positions vacant for budget balancing purposes. We would note, however, that these steps were selectively applied, making it difficult for the Legislature to ascertain how much "forced" salary savings for budgetary purposes remained statewide.

Finance Directed to Address Vacant Positions

Over 6,000 Vacant Positions Abolished in Current Year. Despite these past efforts, many vacancies remained. Control Section 31.60 of the *2002-03 Budget Act* requires DOF to abolish a minimum of 6,000 vacant positions and delete $300 million (all funds) from departments' budgets during 2002-03 (see Figure 1). The control section requires the eliminated positions to come from positions that were vacant on June 30, 2002. The control section also requires that DOF report the abolished positions and any programmatic impacts as a result of the position and funding reductions. As shown in Figure 2 (see page 22), DOF reports that 6,130 vacant positions were abolished and $300 million associated with these positions ($103 million General Fund, $95 million special funds, and $102 million other funds) was deleted from the current-year budget.

A portion of these positions were eliminated pursuant to existing law. As required by Section 12439 of the Government Code, the State Controller abolished 890 positions that were vacant for six consecutive monthly pay periods during 2001-02. Control Section 31.60 permitted these positions to be counted toward the required 6,000 abolished positions.

Partial Augmentations Allowed. Control Section 31.70 of the *2002-03 Budget Act* authorizes the DOF to augment any appropriation reduced pursuant to Control Section 31.60. The section requires that the total augmentation for any fund cannot exceed 50 percent of the total amount deleted for that fund. According to instructions sent to departments, DOF only considered augmentations that (1) would restore the state's ability to collect revenue or (2) were needed to ensure public safety or 24-hour care. The eliminated positions, however, are *not* restored with the augmentations.

Figure 1

Provisions Affecting Vacant Positions

Provision	Description	Reporting Requirements
Control Section 31.60, *2002-03 Budget Act*	Abolishes 6,000 positions in 2002-03 and reduces appropriation by $300 million (all funds).	DOF to report all positions abolished, the associated fund reductions, and any programmatic impacts.
Control Section 31.70, *2002-03 Budget Act*	Authorizes DOF to augment budgets up to 50 percent, by fund, of the appropriations reduced pursuant to Control Section 31.60.	DOF to report on any augmentation and its necessity within 30 days of DOF approval.
Chapter 1023, Statutes of 2002 (AB 593, Oropeza)	Abolishes 1,000 positions by the end of 2003-04 using specified criteria.	DOF to report: • Proposed positions in the Governor's budget. • At least 90 days prior to the elimination of the positions. • By July 2004, in consultation with DPA, on the positions abolished.
Control Section 31.75, *2003-04 Budget Bill*	Authorizes DOF to augment departments' budgets up to the same amount provided in the current year pursuant to Control Section 31.70.	None.

The control section requires that DOF report to the Legislature the necessity of any augmentations within 30 days after approval. In a January 17, 2003 report, DOF reported $36 million in augmentations had been made pursuant to Control Section 31.70 (see Figure 3, next page). Of this amount, $33 million is attributable to General Fund augmentations.

Most of these General Fund augmentations have occurred within the California Department of Corrections (CDC). As part of CDC's Control Section 31.60 reductions, a significant number of vacant correctional officer positions were abolished for a General Fund savings of over $23 mil-

Figure 2

Control Section 31.60—Positions and Funding Deleted[a]

(Dollars in Thousands)

	Positions Abolished	General Fund	Special Funds	Other Funds	Total Funds
Criminal Justice	1,320	$50,197	—	$759	$51,056
Education	150	3,581	$989	3,982	8,552
General Government	903	13,990	20,058	22,823	56,771
Health & Social Services	1,238	14,006	4,470	44,234	62,710
Resources	1,043	12,226	21,311	17,437	50,974
Transportation	1,476	8,866	48,420	13,098	70,384
Totals	**6,130**	**$102,866**	**$95,248**	**$102,333**	**$300,447**

a As reported by the Department of Finance.

Figure 3

Control Section 31.70 Augmentations[a]

(In Thousands)

Department	General Fund	Special Fund	Other Funds	Total Funds
Corrections	$23,783	—	—	$23,783
Franchise Tax Board	5,759	$251	—	6,010
Board of Equalization	3,115	—	—	3,115
Lieutenant Governor	499	—	—	499
State Controller	—	—	$628	628
Secretary of State	—	510	—	510
Industrial Relations	245	52	112	409
Commission on Teacher Credentialing	—	322	—	322
Alcohol Beverage Control	—	295	—	295
Personnel Administration	—	—	275	275
Employment Development	—	210	—	210
Totals	**$33,401**	**$1,640**	**$1,015**	**$36,056**

a As reported by the Department of Finance.

lion. All of that funding, but not the positions, was restored through Control Section 31.70.

Additional 1,000 Positions to Be Abolished by the End of the Budget Year. Chapter 1023, Statutes of 2002 (AB 593, Oropeza), requires DOF to identify an additional 1,000 positions proposed for elimination. These positions are to be abolished by the end of 2003-04. Chapter 1023 requires that DOF:

- Not abolish positions that directly provide 24-hour care, public safety, and critical services to the state.
- Give priority to the elimination of positions that are vacant.
- Give priority to the elimination of administrative and managerial positions that do not provide direct services to the public.

Chapter 1023 requires DOF to notify the Legislature at least 90 days prior to the elimination of the positions. Furthermore, DOF is required to report to the Legislature by July 1, 2004 all positions that were eliminated.

The proposed budget includes 1,900 positions to be eliminated as part of specific program reductions. The administration estimates that only 400 of these positions are currently vacant.

Administration's Reports to the Legislature. In reviewing the control section reports submitted by DOF, the administration has provided most of the information requested. We, however, did find several areas where the information was incomplete. For instance, the submitted report for Control Section 31.70 does not include all of the augmentations included in the proposed budget.

Recommend Updated Information. The reports required by the control sections are helpful to the Legislature in assessing the appropriateness of the budget adjustments made by DOF. To help meet this goal, we recommend DOF provide updated reports this spring that accurately reflect, by fund, all Control Section 31.60 position and funding reductions and Control Section 31.70 augmentations. Also, as additional information is submitted pursuant to Chapter 1023, DOF should categorize the positions proposed to be eliminated by the criteria set forth in the statute.

Administration Requests Authority to Reverse Control Section 31.60 Reductions

New Control Section Included in Budget. The Governor's budget includes a new control section, 31.75, that would authorize DOF to augment department budgets up to the same amount provided in the cur-

rent year pursuant to Control Section 31.70. In other words, this would allow DOF to double the augmentations made through Control Section 31.70. In the case of CDC described above, the proposed control section would give DOF the authority to adjust the budget by over $23 million *more* than the Legislature's enacted budget. Unlike the current-year control sections, Control Section 31.75 requires no legislative notification of augmentations.

Based on current Control Section 31.70 augmentations, Control Section 31.75 would give DOF the authority to augment the 2003-04 budget by $36 million. The DOF, however, can continue to augment departments' budgets using the Control Section 31.70 authority until the end of 2002-03. The full impact of Control Section 31.75, therefore, would not be known until the end of 2002-03.

Proposed Control Section Unnecessary. To the extent that DOF determines additional augmentations are necessary, the department can use the standard budget change proposal process. In fact, DOF is already using this process for such augmentations. For example, the Secretary of State submitted a request for a budget-year augmentation above the 50 percent limit set by Control Section 31.70 (please see our discussion of this specific proposal under the Secretary of State's budget, Item 0890).

Recommend Deletion of Control Section 31.75. Given the above, we do not see a need to grant DOF the authority to augment departmental budgets. Therefore, we recommend the deletion of Control Section 31.75 from the budget bill.

STATE EMERGENCY TELEPHONE NUMBER ACCOUNT

The administration proposes to increase the maximum 911 surcharge rate from 0.75 percent to 1 percent of intrastate phone charges. The administration estimates an additional $50 million would result from the increase and proposes to reimburse state agencies for a number of activities. Since the proposal is inconsistent with current law and changes the nature of the 911 surcharge, we recommend the Legislature reject the proposal.

The budget proposes to shift $47 million in funding for various state activities from the Motor Vehicle Account (MVA) and the General Fund to the State Emergency Telephone Number Account (911). The 911 account is funded through a surcharge that is placed on monthly phone bills.

Background

Current Law Specifies Activities to Be Funded. Revenue and Taxation Code Section 41136 allows government agencies and telephone companies to be reimbursed for equipment and related costs associated with California's 911 phone system. Specifically, as summarized in Figure 1 (see next page), the entities receiving 911 funding are:

- ***Telephone Companies***—to maintain the 911 database and network.
- ***Public Safety Answering Points (PSAPs)***—to replace or upgrade 911 phone equipment for police, sheriff, and fire departments. If a PSAP purchases and installs a computer aided dispatch (CAD) system, reimbursement may be provided for the software interface between the 911 system and the new CAD system, but not the CAD system itself. Personnel costs for answering the 911 calls are *not* eligible for reimbursement.

Figure 1

State Emergency Telephone Number (911) Account Current- and Budget-Year Activities and Costs

(In Millions)

		Estimated 2002-03	Proposed 2003-04
Authorized State Operation Activities			
Department of General Services (DGS)	• Process claims submitted by PSAPs and telephone companies. • Estimate and propose annual surcharge rate.	$1.2	$1.2
Board of Equalization	• Pay DGS-approved claims. • Approve surcharge rate.	0.6	0.6
State pro rata	• General state administrative costs.	3.2	3.5
Authorized Local Assistance Activities			
Telephone companies	• Maintain 911 database. • Maintain 911 network.	106.5	106.5
Public Safety Answering Points (PSAPs)	• Install and maintain 911 systems. • Train staff and coordinate county activities.	35.5	35.5
California Highway Patrol (CHP)	• Answer cellular 911 calls. • Transfer non-state-highway calls to closest PSAP.	4.0	12.9
Proposed Activities			
CHP	• Fund CHP personnel costs for response to 911 calls.	—	28.8
Department of Health Services, Poison Control Centers (PCCs)	• Fund a portion of PCCs' annual budget.	—	3.6
California Department of Forestry and Fire Protection	• Install computer aided dispatch systems in 12 emergency command centers.	—	2.6
Totals		**$151.0**	**$195.2**

- ***Department of General Services (DGS) and the Board of Equalization***—to administer and process the reimbursement claims from the PSAPs and other entities.
- ***California Highway Patrol (CHP)***—to answer cellular 911 calls and transfer those calls unrelated to incidents on state highways to the closest PSAP. On an annual basis, CHP answers about eight million cellular 911 calls. The DGS has authorized this funding because, unlike noncellular 911 calls, CHP must ask several questions to pinpoint the caller's location.
- ***Secondary PSAPs (those PSAPs which do not directly answer 911 calls)***—to replace and upgrade their 911 phone equipment.

Wireless 911 Service Is Being Piloted. In order to install new technology to route cellular calls to the closest PSAP, the Legislature increased DGS' expenditure authority in 2001-02 by $32 million to begin the implementation of wireless 911 service. One of the project's benefits is to reduce the number of cellular calls answered by CHP. The DGS has completed a pilot in San Francisco and estimates that wireless 911 should be statewide within the next few years.

Administration Proposes Additional Activities for Funding

It is our understanding that the administration will propose legislation to increase the maximum 911 surcharge rate from 0.75 percent to 1 percent of intrastate phone charges. This increase is estimated to provide $50 million to fund additional state activities, which we discuss below and illustrate in Figure 1. Since the rate change would not be effective until November 2003, the new revenues would provide a full-year increase of $67 million in 2004-05.

- ***CHP.*** The administration proposes (1) $29 million to reimburse 5 percent of officers' and supervisors' total personnel costs—the estimated time for responding to dispatched 911 calls, and (2) an additional $9 million for answering cellular 911 calls. These activities are currently funded through the MVA.
- ***Department of Health Services (DHS).*** The administration proposes that $3.6 million of DHS Poison Control Centers' (PCCs) budget be funded by the 911 Account. The PCCs' purpose is to prevent poisonings and provide treatment recommendations when necessary. According to the administration, a portion of PCCs' activities consists of receiving and responding to trans-

ferred 911 calls. These activities are currently funded through the General Fund.

- ***California Department of Forestry and Fire Protection (CDFFP).*** The administration proposes $2.6 million in one-time funding to continue the implementation of CDFFP's CAD system, which allows CDFFP to dispatch its resources to emergencies. In 2001-02, CDFFP received $10.4 million General Fund for the development and implementation of the CAD system.

Proposed Activities Do Not Relate to 911 Telephone Systems

We have several concerns with the administration's proposal, discussed in detail below.

Proposed Activities Are Inconsistent With Current Law. The purpose of the 911 Account is to pay the equipment-related expenses of the 911 telephone system. Current law specifies the particular 911 system activities eligible for funding. The administration's proposal, however, does not tie to any of those eligible activities. For example, current law specifies that PSAPs may be reimbursed to upgrade or replace their 911 equipment, not their officers' *response* to the 911 calls. The administration, however, proposes that CHP be reimbursed for its *response* to 911 calls. While the administration could propose trailer bill language to allow the funding of these activities, the proposed activities are inconsistent with the broad intent of current law, which is to provide funding to maintain the 911 system.

Proposed Activities Do Not Relate to Telephone Use. Surcharges or fees should have a direct relationship with the particular services provided. Under current law, telephone users pay 911 surcharges to support the operation of the 911 telephone system. In contrast, the proposed activities would pay for expenses state agencies incur as a *result* of 911 phone calls. For example, the administration proposes to fund CDFFP's continued implementation of its CAD project because the CAD system takes information *from* the 911 system and uses it to manage CDFFP's activities.

Proposal Does Not Treat State and Locals in Similar Manner. California's 911 PSAPs are made up of both state and local agencies. Under current law, PSAPs—regardless of the level of government—may receive reimbursements for the same activities. In our view, equal treatment is reasonable since all responders perform the same activities when maintaining and operating the 911 system.

The administration, however, proposes to change that equal treatment in several ways:

- ***Reimbursement of Response Costs.*** Under current law, PSAPs do not receive funding for personnel costs related to responding to 911 calls. The administration proposes to fund CHP personnel costs related to 911 call responses from the 911 Account. The administration, however, does not propose to fund these same personnel costs for any other PSAP.
- ***Implementation of CAD Systems.*** Most PSAPs use some form of CAD technology to manage their resources when responding to calls. Implementing CAD systems can be very costly and time consuming. The administration proposes 911 funding to complete CDFFP's CAD implementation. The administration, however, does not propose to fund other PSAPs' CAD implementations.
- ***Agencies Receiving Transferred 911 Calls.*** In some situations, PSAPs may transfer 911 calls to agencies that are not typical 911 responders (if they are better able to respond to the needs of the caller). For example, in cases of homelessness, a PSAP may transfer a nonemergency call to a local homeless shelter. These agencies are ineligible for 911 equipment and funding. Since they receive transferred 911 calls, the administration proposes that PCCs—which are currently neither a primary nor a secondary PSAP—receive 911 funding. The administration, however, does not propose to fund any other agency receiving transferred 911 calls.

If current law is changed to allow these additional activities, the change should treat equally all PSAPs.

No Workload Data to Justify Increases for CHP Dispatchers. The CHP answers most cellular 911 calls, for which it currently receives $4 million for staff costs. This annual cost is based on answering 8 million cellular calls. The administration proposes to increase this amount by $9 million but has not submitted any workload data to support the proposed increase.

Recommend Rejecting Proposal. Since the proposal is inconsistent with the intent of current law and changes the nature of the 911 surcharge, we recommend the Legislature reject the administration's proposal. The fiscal effect of this action would fall primarily on the MVA. Please see the "Transportation" chapter of this *Analysis* for a discussion of how the Legislature could address the account's condition.

Proposition 46 Housing Bond

In November 2002, the voters approved a $2.1 billion housing bond. The General Fund will pay an average of $157 million annually for 30 years to pay for the principal and interest of the bonds. In this piece, we review the administration's proposal for implementing the bond's provisions and outline potential options for using the bond to help address the budget situation.

Housing Bond Provides Funding for 21 Programs

Overview of Proposition 46

Proposition 46 (Chapter 26, Statutes of 2002 [SB 1227, Burton]), allocates $2.1 billion in funding to 21 housing programs, as shown in Figure 1 (see page 32). The major allocations of the bond proceeds are as follows:

- ***Multifamily Housing Programs ($1.11 Billion).*** The bond funds a variety of housing programs aimed at the construction of rental housing projects, such as apartment buildings. These programs generally provide local governments, nonprofit organizations, and private developers with low-interest (3 percent) loans to fund projects. In exchange, a project must reserve a portion of its units for low-income households for a period of 55 years. This measure gives funding priority to projects in already developed areas and near existing public services (such as public transportation).
- ***Homeownership Programs ($405 Million).*** A number of the programs funded by Proposition 46 aim to encourage homeownership for low- and moderate-income homebuyers. Most of the funds are to provide downpayment assistance to homebuyers through low-interest loans or grants. Typically, eligibility for this assistance is based on the household's income, the cost of the home being purchased, and whether it is the household's first home purchase.

- ***Farmworker Housing ($200 Million).*** These funds will be used to provide loans and grants to the developers of housing for farmworkers. Program funds are used for both rental and owner-occupied housing.
- ***Other Programs ($385 Million).*** Additional funds are allocated for the construction of homeless shelters, payments to cities and counties based on their approval of housing units, provision of mortgage insurance for high-risk homebuyers, and capital needs of local code enforcement departments.

While most of the programs will be administered by the Department of Housing and Community Development (HCD), some of the programs will be administered by the California Housing Finance Agency (CalHFA). Specifically, CalHFA will administer the preservation (except $5 million administered by HCD), homebuyer's downpayment assistance, nonprofit-sponsored counseling, school facility fees, school personnel, and housing loan insurance programs.

Funds to Be Spent Over Several Years

For the programs with larger allocations of funds (such as the multifamily housing and CalHome programs), the administration proposes to *award* funds over as many as seven years. For some programs, such as the multifamily program, once the funds are awarded to a project, they would not be *disbursed* until many months later—at the time construction was completed.

Some Programs Have Limited Time Periods. For many of the funded programs, the measure limits the length of time available for the funds to be spent. If after a specified length of time—between 18 and 48 months—a program's funds are unspent, they would be reallocated to a different housing program.

LAO Assessment of Proposed Timing. Figure 2 (see page 34) illustrates our estimates of the expenditure of bond funds under the administration's proposal. For the smaller set-asides, the funds are generally proposed to be spent within a few years. Many of the homeownership programs operate on a first-come, first-serve basis—meaning qualified homebuyers will be able to apply as long as funding remains.

As noted above, the allocations for the larger programs are spread out over a number of years. Spreading the allocations out over time reduces the amount of assistance immediately available. At the same time, it should improve the overall quality of the housing funded since HCD funds are awarded largely on a competitive basis. If more funds were awarded in any given year, it is possible that lower-score projects would

Figure 1

Proposition 46
Uses of Bond Funds

(In Millions)

Program	Description	Amount
Multifamily Housing Programs		
Multifamily Housing	Low-interest loans for affordable housing developments. Units reserved for low-income renters in most cases for 55 years.	$800.0
Supportive Housing	Low-interest loans for housing projects which also provide health and social services to low-income renters.	195.0
Preservation	Funds to maintain affordability of units in projects where prior agreements are expiring.	50.0
Housing Trust Funds	Grants to local governments and nonprofit organizations to fund local housing programs.	25.0
Health and social services	Low-interest loans for the construction of space for health and social services connected to affordable housing projects.	20.0
Student housing	Low-interest loans for housing near state universities. Units reserved for low-income students.	15.0
Disabled modifications	Grants for modifications to rental housing to accommodate low-income renters with disabilities.	5.0
Subtotal		$1,110.0
Homeownership Programs		
Homebuyer's Down-payment Assistance	Deferred low-interest loans up to 3 percent of home purchase price for first-time low- and moderate-income homebuyers.	$117.5
CalHome	Variety of homeownership programs for low-income households.	115.0
Building Equity and Growth in Neighborhoods	Grants to local governments to fund homebuyer assistance in high-density developments.	75.0
Nonprofit-sponsored counseling	Downpayment assistance for first-time, low-income homebuyers participating in specified counseling programs.	12.5
Self-Help Construction Management	Grants to organizations which assist low- and moderate-income households in building their own homes.	10.0
School facility fees	Downpayment assistance to eligible homebuyers to cover some or all of the fees paid to school districts to fund new school facilities.	50.0
School personnel	Loans to school personnel for down payment assistance.	25.0
Subtotal		$405.0

Continued

Farmworker Housing Programs		
Farmworker Housing	Low-interest loans and grants for construction of housing for farmworkers.	$155.0
Migrant workers	Low-interest loans and grants for projects which serve migratory workers.	25.0
Health services	Low-interest loans and grants for farmworker housing which also provides health services.	20.0
Subtotal		$200.0
Other Programs		
Emergency Housing Assistance	Grants for the construction of homeless shelters.	$195.0
Jobs-Housing Improvement	Grants to local governments based on the amount of housing they approve.	100.0
Housing loan insurance	Insurance for high-risk housing mortgages.	85.0
Code enforcement	Grants for capital expenditures for local code enforcement departments.	5.0
Subtotal		$385.0
Total		**$2,100.0**

be funded. By spreading the dollars out, there is more time for higher-quality projects to be put together and submit applications. Based on past experience, the funding levels proposed should attract an adequate number of qualified applicants to ensure healthy competition for the funds. Our assessment, therefore, is that the administration's proposal on timing is reasonable.

Broad Legislative Discretion Over Use of Funds

Chapter 26 gives the Legislature broad authority to make changes to the programs funded by the bond proceeds. Specifically, the bond act provides:

> The Legislature may, from time to time, amend the provisions of law related to programs which funds are, or have been, allocated pursuant to this section for the purpose of improving the efficiency and effectiveness of the program, or for the purpose of furthering the goals of the program.

For instance, while $155 million in bond funds must be spent on farmworker housing, the Legislature generally has the ability to alter what type of farmworker housing is funded, who is eligible to receive funding,

and the terms of the funding. Since funding for some of the programs will last for several years, this provision gives the Legislature the opportunity to review a program's effectiveness and make any desired changes.

Figure 2

Proposed Timing of Proposition 46[a]

(In Millions)

	2002-03	2003-04	2004-05	Subsequent Years	Total Housing Assistance[b]
Multifamily Programs					
Multifamily Housing	$70	$132	$134	$442	$778
Supportive Housing	25	35	35	95	190
Preservation	3	22	18	4	47
Housing trust funds	—	13	12	—	25
Health and social services	10	10	—	—	20
Student housing	—	8	7	—	15
Disabled modifications	—	5	—	—	5
Homeownership Programs					
Homebuyer's Downpayment Assistance	$8	$31	$31	$42	$112
CalHome	25	25	25	33	108
Building Equity and Growth in Neighborhoods	—	24	24	24	72
Nonprofit-sponsored counseling	2	6	4	—	12
Self-Help Construction Management	2	4	3	—	9
School facility fees	2	8	8	29	47
School personnel	2	5	5	12	24
Farmworker Housing Programs					
Farmworker Housing	$30	$30	$30	$45	$135
Migrant workers	25	—	—	—	25
Health services	20	—	—	—	20
Other Programs					
Emergency Housing Assistance	$31	$31	$31	$93	$186
Jobs-Housing Improvement	25	25	25	24	99
Housing loan insurance	—	41	40	—	81
Code enforcement	5	—	—	—	5
Totals	**$285**	**$455**	**$432**	**$843**	**$2,015**

a LAO estimates based on administration's proposal.

b Excludes administrative costs.

Some Administrative Costs Are Too High

We believe 5 percent for administrative costs is a reasonable target for each program funded by the bond. We, therefore, recommend a number of reductions to proposed administrative costs—increasing funds available for housing assistance by $13 million. We also recommend that the California Housing Finance Agency provide the Legislature with detailed budgets for each of its programs.

Dollars Spent on Administration Reduce Funds for Housing. Proposition 46 authorizes the use of some of the bond proceeds to pay for the costs of administering the programs. Each dollar spent on administrative costs, however, results in one less dollar available for direct housing assistance. As with the housing assistance dollars, the costs of administration will be financed over the next 30 years.

Many of the programs supported by the bond have limits on the percentage of funds that can be used for administrative costs. For instance, the statute establishing the multifamily housing program limits administrative costs to 5 percent of total program funds.

Governor Proposes $85 Million in Administrative Costs. As shown in Figure 3 (see next page), the Governor proposes a total of $85 million from the $2.1 billion bond (4.1 percent) to be used for administrative costs. The HCD-administered programs have developed cost estimates based on the past operation of their programs. On the other hand, CalHFA has proposed using a flat 5 percent for administration in all of its programs. While most of the proposed administrative levels appear reasonable, we do have concerns in several areas, which we discuss below.

HCD Program Administrative Costs High. The HCD has operated the farmworker, self-help, and CalHome programs over the past few years. Based on this experience, the department proposes spending 10.1 percent, 9 percent, and 6.1 percent, respectively on administrative costs. We believe the department should be able to spend less on administrative costs for these programs. First, prior experience with the programs should lead to the elimination of some "start-up" activities—such as extensive work developing the program funding notices. Second, as applicants apply for funding over multiple years, the need for some technical assistance should diminish. Finally, HCD could reduce long-term monitoring costs by better coordinating with other agencies which provide funding for the same projects. Incorporating these factors into HCD's workload projections would reduce its administrative costs.

Emergency Housing Assistance Program (EHAP) Costs Exceed Statutory Limit. The statute establishing the EHAP program specifically limits its administrative costs to 4 percent of total funds. The administration, however, proposes to spend 4.6 percent of the $195 million on administration.

Figure 3

Proposed and LAO Recommended Administrative Costs

(In Millions)

		Proposed		Recommendation	
	Funding Allocation	Administrative Costs	Percent of Total	Percent of Total	Increased Housing Assistance
Multifamily Programs					
Multifamily Housing[a]	$865.0	$22.1	2.6%	2.6%	—
Supportive Housing	195.0	5.0	2.6	2.6	—
Preservation	50.0	2.5	5.0	5.0	—
Homeownership Programs					
Homebuyer's Downpayment Assistance	$117.5	$5.9	5.0%	5.0%	—
CalHome	115.0	7.0	6.1	5.0	$1.3
Building Equity and Growth in Neighborhoods	75.0	3.0	4.0	4.0	—
Nonprofit-sponsored counseling	12.5	0.6	5.0	5.0	—
Self-Help Construction Management	10.0	0.9	9.0	5.0	0.4
School facility fees	50.0	2.5	5.0	5.0	—
School personnel	25.0	1.3	5.0	5.0	—
Farmworker Housing Programs					
Farmworker Housing[b]	$200.0	$20.1	10.1%	5.0%	$10.1
Other Programs					
Emergency Housing Assistance	$195.0	$9.0	4.6%	4.0%	$1.2
Jobs-Housing Improvement	100.0	1.0	1.0	1.0	—
Housing loan insurance	85.0	4.3	5.0	5.0	—
Code enforcement	5.0	0.3	5.0	5.0	—
Totals	**$2,100.0**	**$85.3**	**4.1%**	**3.4%**	**$13.0**

a Includes housing trust fund, health and social services, student housing, and disabled modifications programs.

b Includes migrant workers and health services programs.

Totals may not add due to rounding.

CalHFA Programs Lack Budgets. While CalHFA has stated that administrative costs will not exceed 5 percent, the department has not presented any budgets or documentation on its proposed expenses. The department has noted that not all of its programs will need the full 5 per-

cent for essential administrative costs. In these cases, the department intends to use any remaining funds for program marketing.

Recommend Administrative Savings. We consider 5 percent for administrative costs a reasonable target for each program (in the absence of alternative restrictions). As such, we recommend that the Legislature reduce all of HCD's proposed administrative costs to a maximum of 5 percent. In the case of EHAP, we recommend the department adhere to the existing statutory requirements. We further recommend that HCD report at budget hearings on any proposed program changes necessary to achieve these efficiencies. As shown in Figure 3, the net effect of these recommendations would be to increase bond funds available for housing assistance by $13 million.

While CalHFA already proposes to meet this 5 percent threshold, it should provide documentation on its proposed administrative activities so that the Legislature can review them for reasonableness. Consequently, we recommend that CalHFA provide the Legislature with detailed budgets for each of its programs. In particular, CalHFA should provide justification for its marketing activities on the basis of need—rather than potentially relying on marketing as a placeholder for spending up to the 5 percent level.

Migrant Services Center Needs Rehabilitation

We recommend the use of $6 million in migrant worker bond funds to support the reconstruction of one of the state's migrant farmworker housing facilities.

Final Year of Reconstruction Deferred. The state owns about two dozen migrant farmworker housing centers throughout the state. The HCD's Office of Migrant Services contracts with local entities to operate these facilities. For the past decade, the department has been implementing a reconstruction plan to renovate the facilities (through a combination of funds from the federal government, the General Fund, and bonds). One center—the Planada facility in Merced County—is still awaiting funding. Due to the budget situation, the roughly $6 million in General Fund dollars scheduled for this project was deferred in the current year, and the Governor again proposes to defer the funding in the budget year. Due to its physical condition, the center will not be able to operate past 2003-04 without reconstruction funds.

Recommend Using Migrant Services Set-Aside. The $25 million set-aside of migrant worker bond funds is intended to build housing for migrant farmworkers. Under the program's existing statutory authorization, only local governments and nonprofit organizations are eligible

to apply for the funds. The reconstruction of the Planada facility, however, is consistent with the intent of the program to assist migrant farmworkers. Consequently, we recommend a $6 million appropriation of bond funds for the project with budget bill language authorizing the expenditure of these bond funds on this state facility. This action would eliminate the need for future General Fund spending on the project and allow the facility to operate in future years.

OPTIONS FOR USING THE HOUSING BOND TO HELP ADDRESS THE BUDGET SHORTFALL

Due to the state's fiscal condition, we have explored the possibility of using funds from the housing bond to help the state address the budget shortfall. Based on our preliminary work, we believe the bond could be used for this purpose—potentially benefiting the General Fund by hundreds of millions of dollars. Below, we outline two such options.

Backfill Redevelopment Housing Funds

Governor's Proposal for Redevelopment Funds. As part of its mid-year proposal, the administration proposed requiring local redevelopment agencies to transfer unencumbered reserves in their low- and moderate-income housing funds to their county's Educational Revenue Augmentation Fund (ERAF). This proposal which would benefit the state's General Fund by reducing state education financing obligations. At the time of this analysis, it was unclear whether this proposal would be adopted by the Legislature. If the Legislature were to adopt a similar proposal in the future, housing bond funds could be used to offset any negative impacts to redevelopment agencies' housing projects.

Bond Funds Could Replace Low- and Moderate-Income Housing Funds. Specifically, the Legislature could specify in law that any redevelopment agency that transfers housing funds to ERAF is guaranteed replacement funding under Proposition 46. To receive this replacement funding, redevelopment agencies could be required to submit a letter to the State Controller's Office indicating the amount of replacement funds needed on a project-by-project basis. The funds could then be disbursed from an appropriate bond program's allocation (for instance, a multifamily project by a redevelopment agency could be funded from the multifamily bond funds). To encourage the timely development of affordable housing and allow remaining state housing bond funds to be used for other housing projects, we suggest that such a "replacement guarantee" be time-limited—say, up to four years.

Funding Switch for Committed, but Not Disbursed, Projects

Millions in Funds Have Not Yet Been Disbursed. Over the past several years, the state has awarded hundreds of millions of dollars in program funds to various housing projects. The original source of the funding was General Fund appropriations to a number of housing special funds. Because funds are often not disbursed until projects are completed, the awarded funds still remain in state accounts today for many of these projects. Estimates suggest that as much as $300 million currently remains in committed, but not disbursed, housing funding.

Option to Switch Fund Sources. As an option, the Legislature could replace the General Fund dollars in the various housing programs with bond funds. To accomplish this, the General Fund dollars could be transferred from the various special funds back to the General Fund. These funds would then be replaced with bond funds on a dollar-for-dollar basis. As a result, no projects would be affected—each would receive the same allocation of funding (but from a different fund source).

Timing Considerations. The estimate of available nondisbursed funds are time-sensitive. Disbursements occur on a regular basis—as projects complete their construction. While roughly $300 million in committed but undispersed state monies would likely be available today, a portion of those funds will be disbursed by the end of the current year. Waiting to enact this option until the *2003-04 Budget Act*, therefore, could substantially reduce the available General Fund savings—perhaps leaving in the range of $200 million available.

Key Considerations

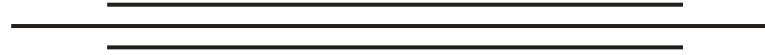
If the Legislature were to pursue the two options outlined above, several key issues should be considered.

Reduced Future Capacity. Under these options, changes to the allocation of housing bond funds would reduce the availability of housing funds in the future. The options would not, however, affect the available funds in the next couple of years. Current plans for awarding funds could continue as planned in the near term, but bond funds available toward the end of the scheduled allocation process would be diminished. At that time, based on legislative priorities, General Fund dollars or future bond act monies would be potential substitute funding sources for the reduced funding capacity.

Legal Considerations. As noted above, Chapter 26 gives the Legislature broad flexibility to make changes to the funded programs. Still, the Legislature is constrained to some degree by the Constitution and case law. Generally, the courts have restricted the Legislature's actions to those

changes which (1) substantially comply with the underlying purpose approved by the voters and (2) do not violate express provisions included in the bond measure.

Our initial review of the housing bond language suggests that these legal restrictions would make it complicated, but not impossible, to implement the changes outlined above. Ensuring that any legislative changes to the housing bond maintained the broad intent of Proposition 46 (with corresponding legislative findings) would help facilitate the successful sale of the bonds. Before implementing changes to the housing bond, we would recommend conferring with Legislative Counsel.



INFORMATION TECHNOLOGY GOVERNANCE

The administration proposes a model for a new state information technology governance structure consisting of three components—a State Chief Information Officer, an oversight board, and state control agencies. Our review found that the proposal lacks details and leaves many questions unanswered. As the administration presents additional information to support its model, we recommend the Legislature evaluate the proposal based on the key objectives of leadership, accountability, and oversight.

The budget includes the administration's conceptual proposal for a new information technology (IT) governance structure to support and manage the state's IT operations. The state's IT governance structure is important because of the magnitude and significance of the state's IT resources. For example, over the last ten years, the state has spent an average of about $2 billion per year on IT purposes including (1) developing, implementing, and maintaining IT systems; (2) operating data centers and telecommunication systems; and (3) purchasing new or updated hardware and software.

These annual IT expenditures are used to support every major state program. For example, the Department of Motor Vehicles uses IT to operate the state's vehicle registration program. To efficiently manage these annual IT expenditures and support state programs, the state must have an effective IT governance structure.

Previous Governance Structures Have Not Been Effective

Since the 1980s, the state has struggled with implementing an IT governance model that provides strong leadership and guidance to the state's IT operations. From the 1980s to the mid-1990s, the Department of Finance (DOF) was solely responsible for approving and overseeing state IT projects. In 1994, after a series of failed IT projects, the Legislature restricted DOF's role solely to budgetary reviews.

Chapter 508, Statutes of 1995 (SB 1, Alquist), established the Department of Information Technology (DOIT) to provide planning and policy guidance to state IT operations. In addition, Chapter 508 authorized DOIT to approve and oversee state IT projects. From 1995 to 2002, DOIT struggled to meet most of its statutory mandates. In 2002, DOIT was not reauthorized by the Legislature and sunset at the end of 2001-02.

As we have discussed in prior publications, the state has experienced a number of problems with its IT projects and operations. Figure 1 summarizes these past problems. The lack of an effective governance structure has at least partially contributed to these problems.

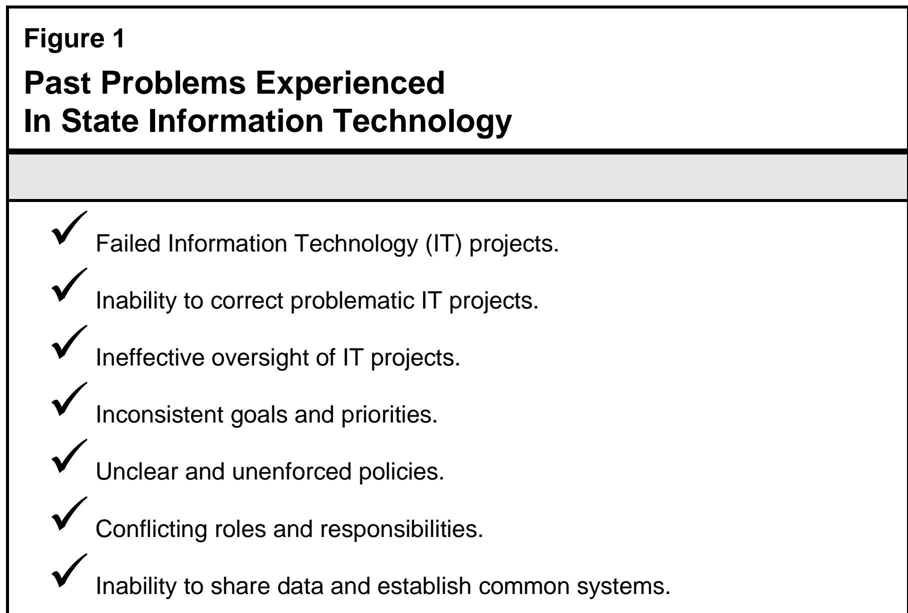


Figure 1

Past Problems Experienced In State Information Technology

- ✓ Failed Information Technology (IT) projects.
- ✓ Inability to correct problematic IT projects.
- ✓ Ineffective oversight of IT projects.
- ✓ Inconsistent goals and priorities.
- ✓ Unclear and unenforced policies.
- ✓ Conflicting roles and responsibilities.
- ✓ Inability to share data and establish common systems.

Recognizing the need for an interim governance structure, the Legislature included $2 million from the General Fund in the current-year budget for DOF to provide some oversight of IT systems. This funding was provided with the understanding that the administration would propose a permanent oversight structure in the budget year.

Governance Model Needs to Address Problems

An IT governance model should have the capability to resolve past problems and avoid potential new ones. There are many ways to design an IT governance model. In our view, however, the state's IT governance

model should be based on achieving the following three key objectives, as summarized in Figure 2:

Figure 2

Information Technology Governance Model Key Objectives

Leadership

- ✓ Provides direction and guidance.
- ✓ Sets goals and priorities.
- ✓ Develops plans and policies.

Accountability

- ✓ Defines roles and responsibilities.
- ✓ Designates specific authority and powers.
- ✓ Helps the public hold government responsible.

Oversight

- ✓ Monitors information technology (IT) projects and expenditures.
- ✓ Directs corrective actions to problematic IT projects.
- ✓ Provides information for budget and policy decisions.

- ***Leadership.*** Leadership provides the direction and guidance on how the state will employ IT in governmental operations and administer its IT investment. Leadership is accomplished through vision, planning, coordinating, and guiding state IT activities and operations.
- ***Accountability.*** Accountability clearly defines the roles and responsibilities of all agencies involved in the state's IT operations. In addition, accountability designates specific authority and powers for the state agencies to accomplish their assigned tasks and activities. Accountability is what helps the public hold government responsible for how it uses taxpayer funds.

- ***Oversight.*** Oversight ensures that state IT operations and projects result in (1) efficient operations and (2) improved services. Oversight monitors IT projects and expenditures, intervenes when expenditures exceed benefits, and ensures that benefits achieved from efficient IT operations are integrated into the state budget. Oversight provides the Legislature with the information it needs when making budget and policy decisions.

Administration's Model Consists of Three Components

Given the state's current fiscal situation, the administration proposes that its new IT governance structure be based on existing resources and current departments. As proposed, the new structure consists of three components: (1) a State Chief Information Officer (CIO), (2) an oversight board, and (3) control agencies.

State CIO Primarily Responsible for Strategic Planning. The CIO would be responsible for formulating plans that address the strategic and operational management of the state's IT investment. The CIO would be responsible for developing policies but would not have any day-to-day responsibilities for IT operations.

Board Would Provide Oversight of Some State IT Activities. The oversight board would consist of the DOF, Department of General Services (DGS), and the the state CIO, with two nonvoting members of the Legislature. The purpose of the board would be to review the plans developed by the state CIO, approve some state IT activities, and oversee some state IT projects. For example, the board would oversee projects with multi-million dollar budgets. Staff support to the board would be provided by existing staff from DOF and DGS.

DGS and DOF Would Provide Primary Oversight of the State's IT Activities. The DGS and DOF would be responsible for updating and enforcing policies on procurement, project development and oversight, and fiscal reporting. Departments would be responsible for complying with these policies. Depending on the characteristics of an IT project, oversight may be provided by the department or DOF. For example, low-risk projects would be monitored by departments, and DOF would provide fiscal control over high-risk projects.

Many Questions Need to be Answered

Currently, the proposal lacks details and leaves many questions unanswered. In attempting to evaluate the proposal, the Legislature will need to focus on (1) the leadership roles of the CIO and the board, (2) the authority of the board, and (3) the oversight roles of the board and the control agencies. We summarize key questions to be addressed in Figure 3.

Figure 3

Proposed IT Governance Model Questions to Be Addressed by Key Objective

Leadership	Accountability	Oversight
State Chief Information Officer (CIO)		
• What leadership role does the CIO perform? • How does the CIO establish goals and priorities? • What plans does the CIO develop?	• What authority and power does the CIO have? • Who approves the CIO's plans? • Who is responsible for implementing the CIO's plans? • What is the role of the CIO in state IT projects? • What is the role of the CIO in developing state IT policy? • How does the Legislature hold the CIO accountable?	• Does the CIO have any oversight duties?
Board		
• What leadership role does the board perform? • What is the relationship between the CIO and the board?	• Is the board advisory or regulatory? • What authority and powers does the board have? • When and how does the board exercise its powers? • How does the Legislature hold the board accountable? • Does the board provide broad representation? • Who appoints the members of the board?	• What are the board's oversight duties? • What types of projects will the board oversee? • Does the board have any fiscal roles or duties?

Continued

Leadership	Accountability	Oversight
Control Agencies		
• What leadership roles do the control agencies perform? • What is the relationship between the control agencies, CIO, and the board?	• Who is responsible for ensuring projects are consistent with state goals and priorities? • Do the control agencies receive additional authority or powers? • When and how do the control agencies exercise their powers? • Who is responsible for correcting problematic IT projects? • Who is responsible for ensuring control agencies issue and enforce their policies?	• How is the Legislature informed regarding when and how oversight is performed?

In addition to the questions outlined in Figure 3, our review has identified two issues for the Legislature's consideration, as described in more detail below.

Composition of Board. We are particularly concerned about the proposed composition of the board. The administration envisions a board composed entirely of administration representatives. In our view, this would not provide different and independent views. To preserve the separation of powers, we also question the desirability of having legislative membership on the board. A better composition of the board would include representatives from non-IT-related private industries, higher education, and/or local government. The Legislature could be responsible for confirming the appointment of at least a portion of these board members.

Need to Set Priorities. Even with an improved governance structure, it is unlikely that all problems can be solved in the near term. For these reasons, we recommend the Legislature set priorities as to what problems should be addressed first. Specifically, we suggest one of the first priorities should be overseeing and correcting problematic IT projects. Second, we suggest that the administration address statewide IT issues such as the role of the state data centers and establishment of common systems to share data. Finally, we recommend the Legislature set the specific timeframes in which to meet the priorities. This would enable the Legislature to hold the administration accountable for meeting legislative direction.

STATE DATA CENTERS—OPTIONS FOR SAVINGS

Chapter 787, Statutes of 1972 (SB 1503, Teale), established the state's current data centers to serve computing needs in specific program areas. The Stephen P. Teale Data Center (TDC) and the Health and Human Services Agency Data Center (HHSDC) are the state's two primary data centers, and they provide computer and network services to various departments and local jurisdictions. The two data centers are funded entirely through reimbursements from departments which use their services, and the budget proposes a combined expenditure authority of $219 million for the budget year. In reviewing these data centers, we found two options that could reduce department expenditures, which we discuss below.

OPTION—CONSOLIDATION OF DATA CENTERS

Single Organizational Structure Could Provide Savings

The organizational consolidation of the Stephen P. Teale Data Center and Health and Human Services Agency Data Center would provide savings while improving operations. This option would provide annual savings—potentially in the range of $8 million ($4 million General Fund). We recommend the administration report on timeframes, potential problems, and anticipated savings from implementing this option.

Chapter 508, Statutes of 1995 (SB 1, Alquist), directed the administration to conduct a study evaluating the benefits of consolidating the existing data centers. The administration's study released in 1997 specifically examined the benefits of (1) consolidating all mainframe systems into one of the existing data centers, (2) outsourcing one entire data center's operations, and (3) placing an existing data center under private ownership and control. The study, however, did not consider all the options for consolidating state data centers. For example, the study did not consider the "organizational" consolidation of state data centers. This

option would consist of creating one organizational structure for two or more existing data centers.

We believe there would be savings (potentially in the range of $8 million all funds, $4 million General Fund) in consolidating HHSDC and TDC into one organization. The current locations of the two data centers would be maintained, and most computer operations would be unaffected. We believe the long-term benefits would outweigh any short-term implementation problems.

Many Areas of Potential Benefits and Savings

We believe savings from organizational consolidation would be realized in a number of areas, as summarized in Figure 1 and discussed in more detail below.

Figure 1

Benefits of Consolidating Health and Human Services Agency Data Center and Stephen P. Teale Data Center

- ✓ One executive and administrative structure.
- ✓ Improved use of excess hardware and software.
- ✓ Reduced hardware and software costs.
- ✓ Reduced impact of pending retirements.
- ✓ Increased efficiencies in supporting existing computer systems.

One Executive and Administrative Structure. Currently, both data centers have their own executive and administrative support teams. For the two data centers, these costs total $25 million. An organizational consolidation would (1) merge the executive team and (2) consolidate administrative support functions.

Improved Use of Excess Hardware and Software. Both data centers purchase large volumes of software and computer equipment every year. For example, the budget proposes expenditure authority increases of $13 million combined for HHSDC and TDC for additional hardware, software, and telecommunications equipment and support. (Our evaluation

of these proposals can be found in the departments' write-ups.) Because excess capacity existing at one site could potentially be used by the other site, we believe an organizational consolidation could decrease annual purchases. For example, if one site had unused equipment, the other site could use the equipment instead of purchasing new equipment.

Reduced Hardware and Software Costs. In addition, each data center conducts its own hardware and software negotiations. The purchase price for similar hardware and software can vary depending on the negotiation skills of the individual data center. By organizationally consolidating the data centers, the administration could decrease hardware and software costs due to consistent negotiating practices and larger purchase amounts. For example, each year both data centers purchase software maintenance agreements. By combining these purchases, the purchase volume would be higher—thereby providing the state with more negotiating power to lower the price of the software.

Reduced Impact of Pending Retirements. Both state data centers have older workforces with highly specialized skills. For example, 50 percent of HHSDC's workforce and 63 percent of TDC's workforce are over the age of 50. As a result, each data center can anticipate losing half of its skilled workforce to retirements in the near future. When the state lacks expertise in technical areas, it has to either recruit new staff or use contractors that often cost more than state staff. By consolidating the data centers, the impacts of the pending retirements could be somewhat mitigated—through sharing remaining staff between sites or consolidating specialized activities at one site.

Increased Efficiencies in Supporting Existing Computer Systems. Both data centers support similar computer systems such as mainframes, servers, and large telecommunications networks. Thus, the same activities to support these systems occur within each data center. Consolidating the data centers would allow efficiencies to occur in how data centers support similar systems. For example, one site could support departments' E-mail systems while another site supports Internet services.

Administration Should Report on Consolidation Option

We believe the full organizational consolidation of HHSDC and TDC could take more than one fiscal year to complete. The savings would depend on what the administration could consolidate in each fiscal year. For this reason, we recommend that the administration examine this consolidation option and report back by spring subcommittee hearings on (1) the timeframes needed to complete administrative consolidation, (2) any potential problems (with potential solutions), and (3) estimates of

anticipated savings by fiscal year. At that point, the Legislature would be in a better position to decide whether to pursue consolidation.

OPTION—CONSOLIDATION OF SERVERS

The state supports thousands of computer servers that are located at state data centers or in departments. Servers located within departments may not be as secure and fully supported as those located at a data center. In addition, state data centers are able to support more systems at a lower cost than most departments. By transferring 2 percent or more of the current servers located in departments to state data centers, we believe a total annual ongoing savings of $6 million ($3 million General Fund) could be realized. We recommend the administration report on timeframes and anticipated savings from implementing this option.

Technology has dramatically changed since the establishment of the data centers in 1972. At that time, mainframes were the only computers available for processing large volumes of data. Now, "servers" (computer systems supporting multiple users using E-mail, office software, Internet, and customized software systems) provide computing power on par with earlier mainframes. Since 1997, both data centers and departments have experienced tremendous growth in these servers. For example, both HHSDC and TDC have experienced a 400 percent growth in servers.

Administration's Policy to Locate Servers in Data Centers Was Not Enforced. One of the recommendations from the administration's 1997 data center consolidation study was to locate servers at a state data center. State policy was further clarified in 1998 when the administration issued a policy requiring certain types of *new* servers to be located at the state data centers.

The administration, however, did not strictly enforce this policy because the (1) data centers were unprepared to support the new systems and (2) departments had some expertise in supporting these systems. Since 1998, the Legislature has approved over $20 million in budget requests to increase the capacity of HHSDC and TDC to support these systems—so the data centers should now have that expertise to do so.

Many Servers Still Located in Departments. Even though HHSDC and TDC now have the capacity to support servers, departments have been allowed to purchase these systems and locate them at departmental sites. Many of these systems provide support to business functions critical to departments' missions. For example, the Employment Development Department uses servers to support employer tax return and payment processing functions.

Servers Located in Departments May Not Be Secure. One of the problems with servers is that these systems are vulnerable to "hacking" (an unauthorized access into the system). State data centers have established security systems and procedures which help to protect servers. It is unclear if departments provide this same level of security.

Servers Located in Departments May Not Be Fully Supported. On a periodic basis, all computer systems should be routinely backed up (software and data is copied onto a disk or tape). In addition, computer systems should be able to recover from hardware or software failures. When computer systems are located at a data center, backup and recovery procedures are included in the overall service. When computer systems are located in departments, backup and recovery procedures vary depending on the department's internal information technology (IT) policies and procedures and staff's technical skills. Thus, at some departments, critical data may be at risk.

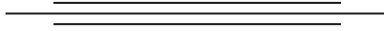
Cost Efficiencies Not Realized for Department Servers. Data centers are able to support more servers with fewer staff because the data centers can (1) purchase specialized hardware and software designed to support large numbers of systems, (2) locate all servers in their computer rooms, and (3) hire staff with more advanced technical skills. In general, departments do not support as many systems so they are unable to purchase the same specialized hardware and software. In addition, departments tend to locate servers throughout their sites. It can, therefore, become time consuming and difficult to fully support these systems. Finally, most departments are unable to obtain IT staff positions of the same quality as state data centers. As a result of these factors, data centers are significantly more efficient as departments in supporting these types of systems.

Locating Servers in State Data Centers Could Save Millions

In 1999, in preparation for the state's Year 2000 efforts, the administration estimated the number of servers located in departments to be in the tens of thousands. These servers perform several different functions. Due to telecommunication limitations though, only some of these servers are appropriate for transfer at this time. We believe about 2 percent of these systems *could* be supported by the data centers in the near term. Based on the efficiencies discussed above, transferring these systems to state data centers could result in annual savings of $6 million ($3 million General Fund). In addition to the savings, we believe this option provides several other improvements, such as greater security and more fully supported computer systems.

As with the previous option, implementation may take more than one fiscal year to complete. The savings would depend on how many

systems the administration could consolidate in each fiscal year. For this reason, we recommend the administration examine this option and report back by spring subcommittee hearings on the (1) timeframes needed to consolidate at least 2 percent of departmental servers at the data centers and (2) estimates of anticipated savings by fiscal year.



DEPARTMENTAL ISSUES

General Government

CONTRIBUTIONS TO THE JUDGES' RETIREMENT SYSTEM (0390)

The state provides retirement benefits for superior, appellate, and Supreme Court judges, and their survivors, through either the Judges' Retirement System I (JRS I) or the Judges' Retirement System II (JRS II). Membership in the JRS II is mandatory for all judges taking office on or after November 9, 1994. These systems are administered by the Public Employees' Retirement System (PERS).

Judges' Retirement System I. Most revenue deposited in the JRS I fund comes from the following sources:

- Active members' contributions, equal to 8 percent of members' salaries ($15 million in 2003-04).
- Fees on civil suits filed in superior courts (approximately $3 million in 2003-04).
- General Fund appropriations ($113 million in 2003-04), equivalent to 8 percent of the salaries of authorized judicial positions ($15 million), an amount for PERS administrative costs ($0.6 million), *plus any amount necessary to cover JRS I benefit payments each year* (proposed $98 million in the budget year under Item 0390).

Members of JRS I earn retirement benefits equal to a percentage (up to 75 percent) of the *current* salary of the judicial office they last held (as opposed to a percentage of their own salary upon retirement, as with all the state's other retirement systems). The JRS I will pay a projected $121 million in benefits to 1,546 annuitants in 2003-04.

Judges' Retirement System II. Chapter 879, Statutes of 1994 (SB 65, McCorquodale), created JRS II. Unlike JRS I, which is funded on a pay-as-you-go basis, JRS II is on a prefunded basis. In this respect, JRS II is like all of the other retirement systems funded by the state. The state and member judges contribute to the JRS II fund each month—8 percent of salary from the judges and approximately 19.2 percent from the General Fund—to provide funds that should be adequate to cover future benefit payments.

Budget-Year Opportunity for General Fund Savings

We recommend that the Legislature reduce the appropriation for the Judges' Retirement System I by $10 million to help address the General Fund shortfall but still leave an adequate reserve. (Reduce Item 0390-101-0001 by $10 million.)

As noted above, the budget includes $98 million General Fund to cover JRS I benefit payments in 2003-04. This amount allows for a reserve of $20 million, or approximately two months' worth of pension payments. While PERS aims for this fund balance level, the reserve was just $5.0 million for 2001-02 and an estimated $8.9 million in the current year. Given the state's fiscal condition, we recommend that the Legislature reduce the appropriation for JRS I by $10 million to help address the General Fund shortfall. This would leave a reserve equal to one month of expenditures.

SECRETARY FOR BUSINESS, TRANSPORTATION AND HOUSING (0520)

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

Business and Regulatory Agencies

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

Transportation Agencies

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

Housing Agencies

- Housing and Community Development
- California Housing Finance Agency

The budget requests $87.7 million for the Secretary's operations in 2003-04. This amount includes $84.6 million for the support of a Traffic Safety Program as the result of a budget-year proposal to consolidate the Office of Traffic Safety (OTS) into the Office of the Secretary. Excluding the new program, support for the Secretary would be $3.1 million in 2003-04, or $347,000 (about 13 percent), higher than the current-year level.

Almost all of the increase is due to higher pro-rata charges that are allocated to the agency for support of general government functions including the State Controller's Office, Department of Finance, and personnel administration. The Secretary's support would include $1.3 million from the Motor Vehicle Account (MVA) and $1.7 million in reimbursements from the agency's constituent departments.

For the Traffic Safety Program, the budget proposes funding to be at the same level as the current year ($84.6 million). Most of the funding will come from federal funds ($84.3 million). The state will provide $344,000 from the MVA as state matching funds.

Minimal Efficiency From Consolidation

The budget proposes minimal savings of one contract staff resulting from the consolidation of the Office of Traffic Safety into the Business, Transportation and Housing Agency. Based on our review, we conclude that greater efficiency in terms of staff savings could be attained. We recommend that the agency identify any additional savings that could be realized from the consolidation and report the information to the Legislature prior to budget hearings. We further recommend a reduction of $39,000 from the Motor Vehicle Account because the amount of state matching fund is overbudgeted. (Reduce Item 0520-0001-0044 by $39,000.)

Since 1967, the OTS has functioned as a separate office under the Business, Transportation and Housing (BTH) Agency. The office's primary responsibility is to allocate federal grant funds to state and local entities to promote traffic safety. Federal law requires the state to provide matching funds to cover a portion of the administrative costs of the program. Currently, the MVA provides about 29 percent of these costs.

The office is supported by 33 staff positions, with a director under contract from the California Highway Patrol. In the current year, total program expenditures are estimated at $84.6 million. Of this amount, $79 million will be awarded as grants. The remaining funds will provide for staff support and operating expenses.

For 2003-04, the budget propose to consolidate the office into the BTH Agency, with funding at the same level as the current year.

Current Program Effectiveness Not a Problem; Budget Identifies Minimal Savings From Consolidation. Discussions with OTS and the BTH Agency indicate that the purpose of the consolidation is not to address any problems related to program effectiveness or efficiency. In this regard, our review found that the grant program has been well administered.

The budget's consolidation proposal identifies relatively small savings—elimination of only one contract position and redirection of the freed-up funds of $135,000 to grants. Our review shows that only $96,000 (the federally funded portion of the savings) should be redirected. Because proposed administrative costs for the Traffic Safety Program in 2003-04 would be lower, the amount of state matching funds required would be less. Accordingly, we recommend a reduction of $39,000 from the MVA.

Savings From Consolidation Potentially Larger. Based on our review, we believe there could be additional savings resulting from the consolidation. For instance, savings might be achieved by consolidating certain administrative functions that both entities now carry out separately. We think that such areas of savings ought be reviewed in order to maximize cost efficiencies from the consolidation. Accordingly, we recommend that the agency identify any additional areas of savings and report to the Legislature prior to budget hearings. Based on this information, the Legislature can determine whether the consolidation should proceed, and adjust the agency's 2003-04 funding level correspondingly.

Agency's Staffing Level Larger Than Budgeted

The agency has expanded its staffing level by "borrowing" positions approved for various departments under the agency. We recommend that the agency provide workload justification for each of the 13 borrowed positions. Any borrowed positions that are not justified should be returned to the loaning departments or eliminated.

The agency is authorized 22 staff positions. The actual staffing level is, however, significantly larger, at 35 positions. The agency has over the years "borrowed" a number of positions from various constituent departments. Specifically, in 1998-99, the agency had eight borrowed positions. Currently, there are 13.

No Justification for Staff Expansion Provided. Current law allows departments to loan positions to one another for short durations under certain circumstances. As the BTH Agency oversees programs and departments covering a broad range of policy areas, it is reasonable for the agency to be able to borrow, on a short-term basis, positions from constituent departments in order to enhance its staff capability to deal with particular program and policy areas as they arise. However, our review shows that the number of borrowed positions in the agency has consistently been significant, at around 13, for the past several years. This, in effect, has enabled the agency to increase its staffing by almost 60 percent without any workload justification or review by the Legislature.

Accordingly, we recommend that the agency submit workload justification for each of the 13 borrowed positions prior to budget hearings. Any positions not justified should be returned to the loaning departments or eliminated since the loaning departments have been handling their workload without them.

LABOR AND WORKFORCE DEVELOPMENT AGENCY (0559)

Created in 2002, the Labor and Workforce Development Agency is responsible for overseeing and coordinating the policy directions, activities, and budgets for the state's labor and employment programs. Specifically, the agency consists of the Department of Industrial Relations (DIR), Employment Development Department (EDD), Agricultural Labor Relations Board (ALRB), and Workforce Investment Board (WIB).

The Governor's budget proposes $2.3 million and 17 positions for support of the agency in 2003-04. This includes $1.9 million in reimbursements, $0.3 million General Fund, and $0.1 million from federal funds.

Agency in First Year of Operation

We recommend that the agency report at budget hearings on steps it has taken to meet the goals specified in Chapter 859, Statutes of 2002 (SB 1236, Alarcón), in its first year of operation.

In 2002, the Governor submitted a reorganization plan to the Legislature proposing the creation of a cabinet-level agency that would consolidate the state's labor- and employment-related programs. Chapter 859 establishes the agency in statute.

Chapter 859 identifies several goals for the new agency. These include:

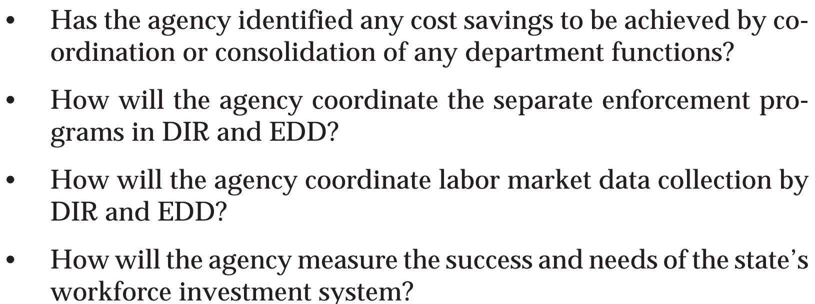
- Achieving cost efficiencies.
- Matching worker training programs with regional labor market needs.
- Improving accountability for programs to meet the needs of the state's workforce investment system.

- Coordinating enforcement, training, and data collection activities.
- Consolidating the availability of labor and employment information in one-stop service centers.

Agency Required to Have No Net Cost. Chapter 859 also required agency funding to come from a reallocation of existing resources in the departments forming the agency (except ALRB). As a result, the agency began operations in the current year with no net cost to the state. The *2002-03 Budget Act* appropriates $1.8 million for the agency. This consists of $1.4 million and 14 positions from EDD, $0.3 million and 3 positions from DIR, and $0.1 million from WIB. Due to late enactment of the budget, however, current-year costs are anticipated to be $1.6 million.

Recommend Report at Budget Hearings. As noted above, Chapter 859 includes particular goals for the agency. We recommend that the agency report at budget hearings on steps it has taken to meet these goals in its first year of operation. For instance:

- Has the agency identified any cost savings to be achieved by coordination or consolidation of any department functions?
- How will the agency coordinate the separate enforcement programs in DIR and EDD?
- How will the agency coordinate labor market data collection by DIR and EDD?
- How will the agency measure the success and needs of the state's workforce investment system?



STATE CONTROLLER
(0840)

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

The Governor's budget proposes expenditures of $106 million ($68 million from the General Fund) to support the activities of the State Controller's Office (SCO) in 2003-04. This amount is a decrease of less than one percent from estimated current-year expenditures. The budget proposes $3.5 million from the General Fund and 32 new positions to implement Chapter 1128, Statutes of 2002 (AB 2834, Migden), to perform audits of local government mandate claims and other duties. In addition, the budget proposes changes to the unclaimed property program, which we discuss below.

Fee Revenues Should Replace General Fund Support For the Unclaimed Property Program

The budget proposes trailer bill language to charge a 3 percent processing fee on the value of approved unclaimed property claims. The budget assumes this fee will result in $3 million General Fund in 2003-04 and $6 million annually thereafter. We recommend that the Legislature adopt a fee to cover the full costs of administering the program ($10.8 million annually). (Reduce Item 0840-001-0001 by $2.4 million.)

Unclaimed Property Program. Since 1959, banks and other institutions have been required by law to remit unclaimed property to the state. The most common types of unclaimed property are bank accounts, safe deposit box contents, stocks, and the proceeds of insurance policies. Prop-

erty is deemed unclaimed when an account has remained dormant for three years and efforts by the institution holding the account to locate the owner have been unsuccessful. The unclaimed property is then transmitted to the State Controller, who maintains records of all such property and attempts to identify the owners. Owners can then file with the SCO to claim their property. Current law requires the SCO to complete its review of all filed claims within 90 days. The SCO approves claims once the owner's identity is confirmed.

$3.2 Billion in Unclaimed Property Held by State. According to the SCO, the state currently holds in excess of $3.2 billion in unclaimed property belonging to over five million individuals and organizations. Historically, the state receives about $300 million annually in unclaimed property funds. In 2001-02, the program returned $190 million, including interest, to approximately 205,000 individuals and organizations. The SCO is projecting a similar level of activity during the budget year.

Governor's Budget Proposes a Processing Fee. The current-year budget includes about $10.8 million General Fund and 140 positions to administer the unclaimed property program. The budget proposes the following:

- A 3 percent or $10 processing fee (whichever is greater) on the value of approved property claims, estimated to generate $3 million in General Fund revenues in 2003-04 and $6 million in 2004-05. The budget assumes that it will take about six months to implement the program in the budget year.
- Extension of the statutory deadline for reviewing unclaimed property claims from 90 days to 180 days.

Fee Appropriate, But Would Not Cover All Costs. We believe the assessment of a fee for this program is appropriate, as customers are receiving a service from the state. A fee would allow the offset of General Fund costs without affecting the level of service provided. The administration, however, is proposing to replace only 56 percent of the General Fund spending with fee revenues.

Recommend Fee to Cover all Program Costs. We recommend that the Legislature impose a fee on all approved claims at a level sufficient to cover administrative program costs. This would result in about $5.4 million in revenues for 2003-04 and $10.8 million in 2004-05—for a General Fund savings of $2.4 million in the budget year and $4.8 million thereafter in comparison to the Governor's budget. We further recommend that the State Controller develop a fee structure that approximates the administrative costs of processing claims.

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 gaming compacts (including the administration and distribution of funds received by the state as a result of Indian gaming activities), (2) is responsible for the licensing and regulation of 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 $51.5 million in expenditures ($46 million from the Indian Gaming Revenue Sharing Trust Fund, $3.3 million from the Indian Gaming Special Distribution Fund, and $2.2 million from the Gambling Control Fund) and 44.7 personnel-years for support of the commission and its activities. In anticipation of renegotiated revenue sharing agreements with tribes, the Governor's budget also assumes $1.5 billion in new revenues to the General Fund, which we discuss in more detail below.

$1.5 Billion Increased Revenue Assumption Risky

The proposed budget assumes $1.5 billion in new revenues to the General Fund in anticipation of renegotiated revenue sharing agreements. The realization of such revenue, however, is unlikely. When the Governor presents the Legislature with the renegotiated compacts, the Legislature will likely need to weigh the impact of increased gaming against the benefit of any increased revenues.

Tribal-State Gaming Compacts Scheduled for Renegotiations. As a result of the passage of Proposition 1A in March 2000, Class III gambling (such as slot machines and banked or percentage card games) became legal on California Indian land for those tribes that enter into a tribal-

state compact approved by the Legislature, the Governor, and the federal government. These compacts lay out the legal relationship between the tribes and the state with respect to Indian gambling. According to the commission, there are currently 109 federally recognized tribes in California, and 61 of these tribes have tribal-state gaming compacts that last until 2020. Of those 61 tribes, 51 are currently operating casinos in California. The compacts have a scheduled renegotiation period in March 2003. The Governor proposes securing $1.5 billion in General Fund revenues as the result of these renegotiations.

Existing Revenue Payments. Currently, pursuant to the compacts, tribes pay $140 million annually to the state for the right to offer Class III gambling. Unlike the Governor's proposal, however, these revenues are not deposited into the General Fund. Instead, the use of the revenues is restricted to specified uses. Specifically, the tribes pay the following:

- ***Revenue Sharing Trust Fund.*** This includes $46 million annually in licensing fees to operate gaming machines. These funds are distributed to noncompact tribes.
- ***Special Distribution Fund.*** This includes $94 million in fees, based on the average net win of machines in operation as of September 1, 1999. (We discuss this fund in detail below.)

Is the Projected $1.5 Billion in Increased Revenues Likely? It is unknown what amount of revenue, if any, will result from the renegotiations. Yet, in our assessment, it is unlikely that the Governor will secure $1.5 billion in budget-year revenues because:

- Under federal law, the Governor cannot impose a tax on the tribes, therefore, the tribes must agree to pay any additional monies.
- The $1.5 billion proposed is ten times what tribes currently pay, and about 30 percent of their current annual gross revenue of $5 billion.
- The budget proposes that the collected revenues go directly to the General Fund, as opposed to the current policy, in which the revenues are used largely in a manner related to the tribes or gambling.
- Since the renegotiated compacts also need to be approved by the federal government, it may be difficult to implement any changes to revenue payments to ensure full-year revenues in the budget year.

The compacts are voluntary agreements, and some tribes could choose to continue to operate under the existing agreements for nearly two more decades. As such, the administration will likely have to negotiate away

items of significant value to secure any sizable increases in revenue. For instance, some existing compact tribes have already expressed interest in an expansion of their gaming.

Gaming in Other States. Connecticut and New York are often offered as examples of states that collect significant revenues from gaming tribes. In Connecticut, gaming tribes contribute 25 percent of their net win from slot machines to the state. In New York, a large tribe contributes up to 23 percent of its net wins. According to the commission, these collection rates were established as part of the original compacts, not through renegotiated compacts. Consequently, the conditions in which these states' original compacts were negotiated are different than that of California today. California's tribes can opt to continue to operate under the original compacts.

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

Special Distribution Fund—Opportunity for General Fund Savings

The $88 million in available monies in the Special Distribution Fund presents the Legislature the opportunity to help address the budget shortfall. We recommend that the Legislature use the available funds for existing programs, currently funded with General Fund dollars, which address the impact of gambling on communities.

How the Special Distribution Fund Works. Revenues to the fund are dependent on the number of slot machines in operation as of September 1, 1999. Tribes contribute revenues each quarter to the fund, up to 13 percent of the average net win from these machines. Figure 1 (see next page) summarizes how these contributions are made based on the number of machines. The commission is responsible for collecting the appropriate amount of payments into this fund. Pursuant to the compacts, the first quarterly payments into this fund began September 30, 2002. As noted above, tribes are expected to contribute $94 million to the Special Distribution Fund in the budget year.

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

- Reimbursement for state regulatory costs associated with implementation of the compacts.

Figure 1

Special Distribution Fund Payments by Tribes

Machines Operating As of September 1, 1999	Percent of Average Quarterly Net Win[a]
1 to 200	—
201 to 500	7%
501 to 1,000	10
Over 1,000	13

[a] Fee is based on number of machines in each increment.

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

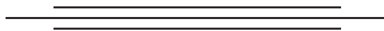
The language of the last item appears significantly broad to allow the funds to be used for any purpose. Yet, a federal district court has ruled that, since this broad statement follows four specific statements related to gambling, all of the funds must be used for gambling-related activities.

No Spending Plan From Governor. Based on current information, total resources in the Special Distribution Fund will be roughly $102 million ($94 million in payments from tribes plus interest and other revenues). The budget proposes expenditures of about $14 million, almost exclusively for Indian gaming regulatory activities. The administration, however, does not propose expenditures for the remaining $88 million in the fund.

Funds Could Be Used to Alleviate General Fund Pressures. In reviewing the options for spending the fund balance, there are many possible uses. The impacts of gambling are widespread, even in communities without casinos. Costs related to public safety, road maintenance, and gambling addiction, for instance, affect many cities, counties, and the state. The costs of addressing even one of these areas would easily exceed the Special Distribution Fund's funding.

Given the budget situation and broad parameters of the fund, we recommend using the $88 million for spending which both meets the requirements of the fund and helps the budget situation. For instance, funds currently spent by the General Fund on gambling-related expenses could be replaced with Special Distribution Fund revenues—generating General Fund savings. Below, we outline two such possible uses for the fund revenues as illustrative examples:

- ***Public Safety Demands.*** Gambling activities increase the needs for law enforcement services throughout the state. We therefore believe the Special Distribution Fund could appropriately be used to address these public safety demands. In total, cities and counties spend billions of dollars annually on public safety. The state contributes a small amount of this total annually ($116 million from the General Fund) though the Citizens' Option for Public Safety (COPS) program. If the Legislature continues to fund the COPS program, a portion of the funding could be directed from the Special Distribution Fund. Given the large amounts of money being spent, it is reasonable to assume that such a small COPS-related portion of total public safety expenditures is already spent on gambling-related activities.
- ***Treat Gambling Addiction.*** There are currently many individuals with gambling problems. It is reasonable to assume that some individuals that suffer from this problem seek mental health services. Currently, several hundreds of millions in General Fund dollars are allocated to counties to provide mental health services at the local level. As with the public safety example above, a portion of these General Fund expenditures could be replaced with Special Distribution revenues.



BOARD OF EQUALIZATION
(0860)

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

The *2003-04 Governor's Budget* proposes $321 million in support of BOE operations, of which $199 million is from the General Fund. This proposal represents a slight increase in overall support from the estimated $320 million in 2002-03, and level support from the General Fund. The number of personnel-years for the BOE is budgeted to remain stable for 2003-04 at 3,840.

SALES TAX SIMPLIFICATION

We recommend that the Board of Equalization report at hearings regarding the impact—both budgetary and revenue related—of participating in the Streamlined Sales Tax Project and adopting the project's multistate agreement.

The sales and use tax (SUT) is one of the state's major revenue sources, accounting for an estimated $23.7 billion in 2003-04, or approximately one-third of total General Fund revenues. In addition, the SUT constitutes a significant share of revenues for cities, counties, and other local

governments. The SUT is levied on the sale of tangible personal property consumed or used in the state, and is generally remitted by the seller to the Board of Equalization (BOE).

Administration and Collection of the SUT. Retailers in California are required to file with the BOE as registered sellers. These registered in-state sellers collect the SUT from purchasers and remit the proceeds monthly or quarterly to the state. Sellers that have no physical presence (or "nexus") in California cannot be required to register with BOE or collect the SUT. Thus, "remote sales" (sales through mail order, telephone, or the Internet) to Californians from an out-of-state business with no nexus in the state are not subject to sales tax collection by the seller.

Although the out-of-state sellers are not required to collect the sales tax on behalf of California, the resident purchaser is still required to submit an equivalent tax—the use tax—directly to the BOE. Despite this requirement, however, the enforcement of this use tax is virtually impossible in the great majority of situations; in fact, many Californians may not even be aware of the tax's existence. Typically, the use tax is collected from individual consumers only in situations requiring registration of personal property by the state (for example, motor vehicles).

Legal Restrictions on SUT Collections

States are prevented from requiring out-of-state sellers to collect the SUT due to a series of U.S. Supreme Court decisions regarding remote sales. Through its rulings on these cases, the Court has determined that allowing states to require SUT collection by out-of-state sellers would violate the Commerce Clause of the U.S. Constitution, which reserves for Congress the ability to regulate interstate commerce. However, Congress *can* adopt legislation allowing states to collect the tax on remote sales. Thus far, Congress has chosen not to do so.

State Sales Taxes Can Be Administratively Burdensome. Currently, 45 states levy a SUT on the sale of personal tangible property. Although states share some similarities in their SUT, many substantial differences exist. Not only do *rates* vary considerably across states, but the *base* upon which the tax is levied varies as well. Adding substantial complexity is the fact that the *definitions* of various goods comprising the base also vary. Thus, what may be taxable at a certain rate in one state may be tax exempt in another. Similar differences also exist among local government jurisdictions. The complexity inherent in these diverse state SUT systems helps explain why court decisions have gone against state efforts to require sellers to collect taxes on remote sales.

Internet Sales Constitute a Revenue Threat. Remote sales across state lines have posed a problem for state revenue systems for some time.

However, the advent and increased development of the Internet has caused additional concerns to be raised regarding the amount of potential SUT revenues that go uncollected. Based on estimates from the U.S. General Accounting Office (GAO), it is likely that the revenue losses to California stemming from all remote sales are in the mid-to-high hundreds of millions of dollars annually. Studies by other governmental agencies (federal and state) as well as academic estimates confirm the magnitude of the GAO estimates. We also note that the existing tax treatment of remote sales results in tax inequities based on the method through which commerce is conducted. For example, a book purchased over the Internet is not subject to taxation while a book purchased from a store in California is.

States Are Attempting to Address the Issue

In an effort to simplify various states' SUT systems, 34 states (and the District of Columbia) that levy the SUT—representing approximately 64 percent of the total population—have participated in the Streamlined Sales Tax Project (SSTP) and adopted related model legislation. These participating states are shown in Figure 1.

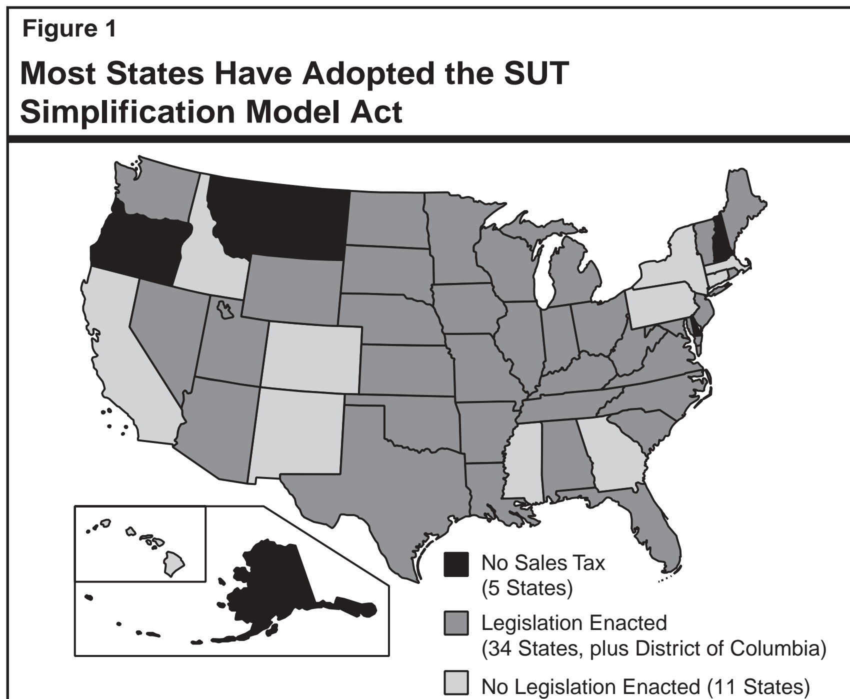


Figure 1

Most States Have Adopted the SUT Simplification Model Act

The SSTP adopted the Streamlined Sales and Use Tax Agreement in November 2002, which creates a blueprint for a simplified tax collection system and attempts to remove the burden and cost of tax collection from sellers. The agreement addresses issues associated with tax collections, definitions of the tax base, uniformity of tax bases, electronic registration of sellers, simplification of tax rates, simplification of returns and remittances, uniform sourcing rules, as well as other issues. This agreement will now be submitted to the individual states for ratification.

Participating states in the SSTP anticipate that the interstate agreement will lead to voluntary participation by businesses and the subsequent petitioning of Congress to allow states to require out-of-state collection of their sales taxes. It is important to note that the simplification effort would not itself result in states being able to require that out-of-state sellers begin collecting the SUT. Rather, the interstate agreement represents an effort on behalf of the participating states to demonstrate to Congress that the simplified sales tax system does not impose unfair costs on out-of-state businesses and thus would not interfere with interstate commerce. Federal legislation would still be needed that would allow states to require out-of-state sellers to collect the SUT.

California Not Participating in Sales Tax Simplification Efforts

In our January 2000 report entitled *California Tax Policy and the Internet*, we recommended that the Legislature pursue multistate agreements to minimize foregone revenues, reduce tax inequalities, and lessen administrative costs. During the 1999-00 legislative session, the Assembly and the Senate approved SB 1949 (Costa), which directed the Governor to enter into discussions with other states regarding the development of a multistate, voluntary, streamlined system for sales and use tax collection and administration. The BOE was neutral on this bill. This legislation was vetoed by the Governor, based on his view that California participates in a number of other multistate forums where taxes are discussed.

While California does participate in a number of multistate organizations—including the Federation of Tax Administrators, the Multistate Tax Commission, the National Conference of State Legislatures, and the National Governors' Association—the SSTP has become the avenue through which each of these organizations have put their efforts with respect to SUT simplification.

The BOE Should Report Regarding California's Participation in Multistate Efforts

In view of the existing and potential revenue implications of Internet and other remote sales activity—as well as for reasons of tax neutrality—

we recommend that the Legislature direct the BOE to examine the advantages and disadvantages of participating in the interstate agreement and report its findings at budget hearings. When the current federal moratorium on state and local taxes on Internet access expires in November 2003, it is possible that Congress will address the issue of whether states will be granted the authority to require that out-of-state sellers collect states' SUT. Thus, a rapid and thorough examination of the costs and benefits of California's adoption of the multistate agreement is recommended. While these efforts would not result in immediate budget impacts, they are important in terms of ensuring California's input on one of the most significant current tax issues.

STATE OPTIONS CONCERNING CIGARETTE TAX EVASION

Cigarette smuggling and related tax evasion is a current concern in California, as well as in many other states. In view of the administration's proposal to more than double cigarette excise taxes, the incentives for such evasion are likely to increase. This analysis presents options the state could take to address this issue.

Current Taxation of Cigarettes and Tobacco Products

Currently, the state levies an excise tax on the sale of cigarettes at the rate of 87 cents per pack, assessed at the cigarette distributor level. The great majority of revenues raised through this excise tax—77 cents per pack—are dedicated to special funds, with the remaining portion going to the General Fund. The cigarette excise taxes are allocated as follows:

- 50 cents per pack is deposited in the California Families and Children First Fund—established pursuant to Proposition 10 (approved by the voters in November 1998)—and used for early childhood health and education programs.
- 25 cents per pack is deposited in the Cigarette and Tobacco Products Surtax Fund—established pursuant to Proposition 99 (approved by the voters in November 1988)—and used for tobacco-related education and research purposes.
- 10 cents per pack is deposited in the General Fund and available to be used for any governmental purpose.
- 2 cents per pack is deposited in the Breast Cancer Fund—established pursuant to 1994 legislation—and used for breast cancer research.

In addition to the tax on cigarettes, other tobacco products—such as pipe tobacco, snuff, and chewing tobacco—are subject to a similar tax based on their wholesale price. The revenue generated by taxes on these other tobacco products is entirely allocated to special funds. The federal government also subjects cigarettes to an excise tax (the rate is currently 39 cents per pack). The state and local SUT is levied on the retail price of the cigarettes (inclusive of the state and federal excise taxes).

Cigarette Tax Revenue

Excise Tax Revenue Has Increased Only With Tax Increases. Revenue received from the taxation of cigarette and tobacco products from 1992-93 through 2002-03 is shown in Figure 2. While revenues from the cigarette excise tax have increased over the 12-year period as a whole, these increases have resulted entirely from increases in cigarette and tobacco products taxes. Specifically, revenues stemming from the excise tax have only displayed growth during this period when the tax was increased by 2 cents per pack as a result of 1994 legislation and by 50 cents per pack as result of the passage Proposition 10 in November 1998.

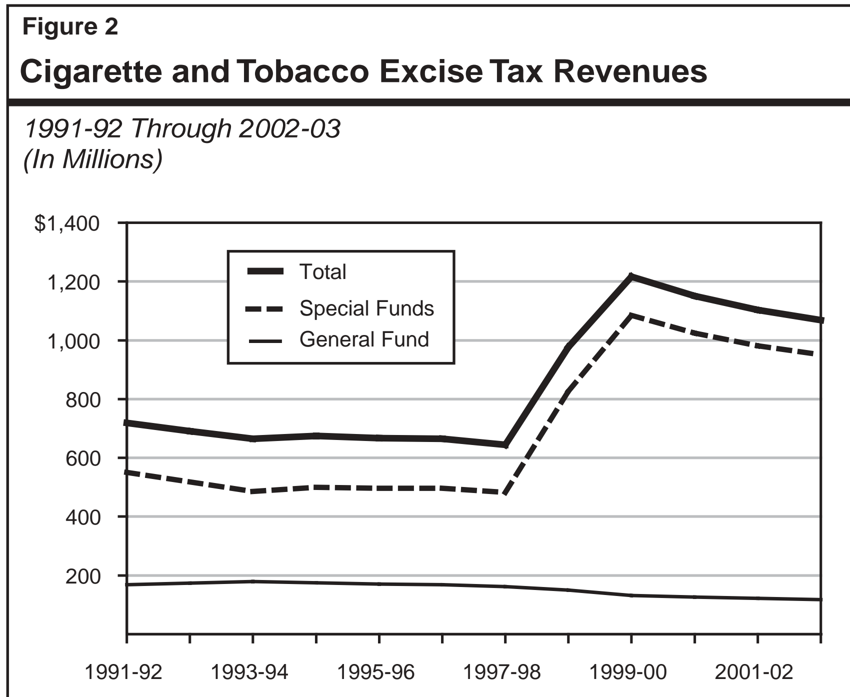


Figure 2

Cigarette and Tobacco Excise Tax Revenues

1991-92 Through 2002-03
(In Millions)

Per Capita Consumption Is Declining. Despite California's growing population, overall consumption of cigarettes—as measured by official data—has declined over the recent past, as shown in Figure 3. This is because per capital consumption of cigarettes has declined sharply, as also shown in the figure, and this decline has not been compensated for by the expanding population growth. These official consumption figures are based on data collected through the sale of cigarette tax stamps (which are purchased by distributors and provide the means for the state to collect the excise tax). (For a further discussion of issues related to the cigarette excise tax, see our discussion of the Governor's cigarette tax proposal in Part V of *The 2003-04 Budget: Perspectives and Issues.*)

Figure 3

Total and Per Capita Cigarette Consumption Is Dropping

1991-92 Through 2000-01

	Total Consumption[a]		Per Capita Consumption	
	Amount[b]	Percent Change	Amount[b]	Percent Change
1991-92	2,144	-2.4%	69.1	-1.1%
1992-93	2,010	-6.3	64.2	-7.1
1993-94	1,903	-5.3	60.1	-6.4
1994-95	1,871	-1.7	58.6	-2.5
1995-96	1,811	-3.2	56.2	-4.1
1996-97	1,777	-1.9	54.4	-3.2
1997-98	1,717	-3.4	51.7	-5.0
1998-99	1,568	-8.7	46.4	-10.3
1999-00	1,390	-11.4	40.6	-12.5
2000-01	1,324	-4.8	38.0	-6.4

[a] In millions.

[b] Packs of cigarettes.

Why Has Cigarette Consumption Declined? There are several reasons for the decline in consumption. First, there has been a drop in the propensity to smoke based on both health concerns and smoking restrictions in the workplace and public areas. Generally, this *secular* decline related to nonprice factors has been in the range of 2 to 3 percent annually during the previous decade. Second, the increased price of cigarettes has resulted in consumption declines. Recent price increases in cigarettes

have stemmed both from manufacturers' price increases (partially as a result of the national tobacco settlement), and increased excise taxes at both the state and federal levels.

In addition, some of the *apparent* decline (based on official statistics) may not reflect an *actual* decline in smoking, but rather the consumption of *untaxed* cigarettes obtained from various sources. Recent reports—for example, a report from the U.S. GAO in August 2002—suggest that various cigarette tax evasion activities are partially responsible for the apparent decline in tobacco tax revenues that is reflected in the official data, as we discuss below.

Types of Cigarette Tax Evasion Activity

Cigarette tax evasion can come in a variety of forms, and includes both cigarette stamp counterfeiting as well as cigarette smuggling across borders (commonly referred to as "butt-legging"). The main forms of tax evasion are:

- ***Stamp Counterfeiting.*** This involves the replication of California's cigarette stamps and their placement on cigarette packs. The Legislature approved legislation in Chapter 881, Statutes of 2002 (SB 1701, Peace), that authorizes the BOE to replace the existing stamps with encrypted indicia as a means of limiting this form of evasion.
- ***Export Redirection.*** This activity involves redirecting cigarettes meant for export to other states, countries, or duty-free concerns (and therefore not subject to the state's excise tax) back into the state so as to circumvent taxation. This diversion can occur either at the cigarette manufacturing or distribution level.
- ***Cross-Border Smuggling.*** This involves the acquisition of cigarettes in other states or other countries (with lower excise taxes than California's or no excise taxes at all) and their transportation into California without the payment of the tax. These would be distributed through legitimate retailers or through the underground economy, or directly consumed by the purchaser.
- ***Internet Purchases.*** This method simply involves the purchase of cigarettes by individuals or companies from cigarette distributors in other countries or—more typically—other states with lower cigarette taxes than California. These can be resold, but more often are simply purchased for individual consumption.
- ***Unstamped Products.*** This method would include the unauthorized acquisition of unstamped cigarettes from tribal or military sources (both of which have legitimate access to unstamped ciga-

rettes). In general, purchases from these sources by individuals other than those specifically eligible, is illegal. Cigarettes obtained in this manner are then consumed directly or resold through the underground economy to stamp counterfeiters.

- ***Overt Criminal Activity.*** This activity involves robbery of cigarette manufacturers or the hijacking of distributors' trucks, prior to cigarette stamps being affixed to the packs.

Counterfeiting Is the Most Significant Issue. According to a recent BOE survey of about 1,300 retail establishments (largely in the San Francisco Bay Area and the Los Angeles area), about one-quarter of the retail outlets had cigarettes with counterfeit stamps (which often can be detected only with specialized techniques). Furthermore, an estimated 10-to-20 percent of cigarette sales from these outlets constituted sales involving such counterfeit stamps.

As noted above, the Legislature has taken action to address the stamp counterfeiting issue by adopting SB 1701. The new process being pursued by BOE using encrypted tax indicia is expected to be completed by January 1, 2005. The BOE legislative analysis of the bill indicated that staff was unable to provide a revenue estimate of the impact of the new indicia system, but BOE staff has indicated that they expect it to reduce the level of tax evasion "to a significant degree." The BOE has subsequently indicated that this program will result in additional cigarette tax revenue of between $9 million and $26 million annually, beginning in 2004-05.

Border Activity Is Also a Significant Problem. According to the BOE, out-of-state activity—including smuggling, sales over the Internet, export diversion, and other similar activity—together constitute another large proportion of the tax evasion problem. With state cigarette excise taxes ranging from 25 cents per pack in Virginia to $1.50 per pack in New Jersey and New York, the opportunities for cross-border activity are apparent. Although California's geographic circumstances insulate the state from certain types of cross-border activity, there are still opportunities for illegal behavior due to variations in the tax treatment of cigarettes. According to BOE surveys and calculations, the incentives for such activity can be substantial. For example:

- Cigarettes cost in the range of $10 to $15 per carton in Mexico versus $30 to $40 in California. This is likely to provide motivation for large-scale smuggling activity sufficient to compensate for risks and costs associated with such activities.

Similarly, the potential revenue losses by the state are significant for relatively small operations. For example:

- The BOE has estimated that the loss in excise tax revenue from a load of cigarettes in a 14-foot panel truck would be on the order of $180,000. For a 24-foot truck, the corresponding loss would approach mid to high hundreds of millions of dollars.

The existence of counterfeit cigarettes (often manufactured overseas and patterned after major brands) can substantially increase the financial rewards accorded various smuggling activities, since the mark-up realized by the smuggler can be considerable.

How Significant Is Cigarette Tax Evasion?

Cigarette tax evasion is important in terms not only of the current revenue losses that it causes, but also in view of proposed cigarette tax increases that would make evasion even more of a problem.

Current Revenue Losses. Because cigarette tax evasion activity is by its very nature part of the informal or underground economy, estimates on the magnitude of the problem are approximations. Nevertheless, the Advisory Commission on Intergovernmental Relations has developed a methodology leading to a general finding that 25 percent of the apparent decline in cigarette consumption due to a price increase results from evasion with the remaining 75 percent due to actual consumption decline. While this response is consistent with long-term consumption responses, the short-term evasion response would typically be somewhat less. This is because it usually takes some period of time for new patterns of consumption (and evasion) to become established.

The BOE has indicated that in the short term, the amount of apparent consumption decline due to evasion would be on the order of 12 percent, with a longer term response of 25 percent. Employing this methodology together with current levels of cigarette sales, BOE staff has bracketed the current revenue loss due to cigarette tax evasion between $130 million and $270 million annually.

Additional Losses Due to a Tax Increase. The *2003-04 Governor's Budget* proposes to increase the cigarette tax by $1.10 per pack as part of the Governor's realignment proposal. The revenues generated by the tax would be deposited in the Enhanced State and Local Realignment Fund (ESLRF) and used to fund various programs whose responsibility—under the proposal—is shifted to local governments. A minor portion of the revenues ($96 million) would be used to backfill the loss in revenue (due to decreased consumption stemming from the tax increase) to the Cigarette and Tobacco Products Surtax Fund, the California Children and Families First Fund, and the Breast Cancer Fund.

Although the state has taken recent steps to counteract the effect of stamp counterfeiting in an effort to reduce the amount of cigarette tax evasion, this program will not fully be in force until 2005. Thus, in the near term, we would expect to see a continued evasion rate on the scale identified in BOE's analyses. Based on the estimated revenue impact of the current level of evasion, the proposed cigarette tax increase would result in additional annual revenue losses from tax evasion, possibly in the range of the high tens of millions of dollars. In addition, the increase in the price of cigarettes resulting from any tax increase would have the effect of encouraging additional smuggling.

What Can California Do About Cigarette Tax Evasion?

As noted above, the state has already taken some important steps in counteracting tax evasion activity. However, there are two additional areas that present significant opportunities. The first is based on *increased federal participation* in enforcing or enhancing existing cigarette and tobacco laws and regulations with respect to the reporting of cigarette and tobacco sales across state lines. The second involves additional *cigarette tax enforcement activity* on the part of the investigations division of BOE.

Federal-State Enforcement

The Federal Jenkins Act. The Jenkins Act (15 U.S.C, Sections 375-378) requires the sale or shipment of cigarettes and tobacco across state lines (to other than a licensed distributor) to be reported by the cigarette seller or distributor to the tobacco tax administrator in the purchaser's state of residence. States may not require the seller to directly levy and remit any taxes due in the purchaser's state; however, state governments may attempt to collect any tax owed directly from the purchaser.

The Jenkins Act applies to the sale or shipment through any means that cross state lines and has been in place since 1949. However, the Act has taken on increasing importance as the Internet has rapidly developed as a means of purchasing cigarettes in small lots or in bulk. The GAO report cited previously lists the web addresses of some 150 dealers who ship cigarettes through Internet transactions. The GAO indicates that compliance with the Jenkins Act is poor (although it presents no overall quantitative measure). Its survey of 150 Internet sellers revealed that 78 percent of the Web sites state that they specifically do not comply with the Jenkins Act. One Internet seller states the following on its homepage, "We will not divulge your information to any third party without either your express consent or as directed by the lawful order of a court of proper jurisdiction."

Enforcement of the Jenkins Act—the violation of which is a misdemeanor—falls under the purview of the U.S. Department of Justice and the Federal Bureau of Investigation. However, according to the GAO report, neither of these agencies has taken any actions to enforce the Jenkins Act with respect to Internet cigarette sales. (The Bureau of Alcohol, Tobacco and Firearms [ATF] of the U.S Department of Treasury, which has ancillary enforcement authority, has conducted three investigations of Internet cigarette sellers related to Jenkins Act requirements.)

California's Efforts to Enforce the Jenkins Act. The BOE has indicated that the state is losing approximately $15 million to $20 million annually through nontaxed Internet sales of cigarettes. In an effort to enforce the Jenkins Act, BOE contacted what it believes is about 10 percent of Internet sellers, in order to request purchaser information. During its Jenkins Act compliance program (May 1999 through September 2001), BOE contacted 167 out-of-state sellers and received responses from 20 of them. As a result, approximately 23,500 residents of the state were notified of their tax obligations, 13,500 of which responded.

The BOE's efforts at enforcing the Jenkins Act resulted in additional gross revenues of $1.4 million—or less than 5 percent of annual estimated tax evasion through Internet sales. Staff at BOE indicated that additional reporting occurred in the initial stages of this effort, but that since this period ended, reporting by all out-of-state sellers is substantially reduced. California currently has no ability to force reporting by out-of-state sellers, and voluntary compliance by California residents is generally poor.

LAO Recommendation: California Should Urge Federal Action. Collecting excise taxes on Internet sales of cigarettes, as well as on other types of cross-border tax evasion, requires cooperation from both other states and the federal government. We recommend that the Legislature memorialize Congress to enact measures that facilitate the collection of excise (and sales) taxes on such sales of cigarettes. The Multistate Tax Commission—a compact of state governments of which California is a member—adopted a resolution in 2001 supporting legislation that would enhance states' abilities to enforce the Jenkins Act.

The GAO report indicates that giving ATF additional investigative authority would increase compliance under the Jenkins Act and allow more collection of excise and sales taxes owed to states. This change would allow ATF to initiate investigations on its own for the express purpose of pursuing Jenkins Act violations. Other actions by the federal government that would aid in the collection of state cigarette taxes and that California may wish to encourage include:

- Amending the Jenkins Act to provide states the authority to seek injunctions against shippers who violate the act.

- Adopting federal legislation to prohibit the shipment of cigarettes through the U.S. Postal Service (as is currently the case with alcoholic beverages).
- Enacting federal statutes that would establish requirements with respect to the delivery of cigarettes by common carriers (for example, requiring proof of age by the purchaser or notification of the state tobacco tax administrator).

Expanded State Enforcement

In addition to the cigarette tax stamp anticounterfeiting measures that the BOE is undertaking pursuant to SB 1701, there are other enforcement steps the Legislature could consider in order to enhance the collection of cigarette excise taxes and related sales taxes.

Current State Enforcement Efforts. Enforcement activities are designed to prevent the loss of revenue through tax stamp counterfeiting, butt-legging, tax underreporting, smuggling, and illegal sales of cigarettes and tobacco products. Field inspections are made of distributors' stamping machines to ascertain that indicia are properly affixed. Investigations also are made of cigarette stocks in retail stores and vending machines. Investigators also undertake spot inspections of transit vehicles, vessels, and aircraft in order to deter illegal transportation of untaxed cigarettes and tobacco products into California.

In the aggregate, the BOE's tax-related enforcement and investigations staff of 55 personnel-years are centralized, as opposed to being distributed among its various individual tax programs. Funding for the investigations division is based on enforcement activities associated with the various taxes, with resources allocated to the taxes generating the highest return. The *2002-03 Governor's Budget* proposed an increase in enforcement activities for cigarette excise taxes and a shifting of funding for this purpose from the General Fund to various special funds. While there was a shift in funding sources, the proposal to expand overall activities in the enforcement and investigations areas did not become part of the budget. Overall funding for the program in the current year is $2.4 million—with a modest 2.3 percent increase proposed for the budget year.

Recent Cigarette Tax Enforcement Proposals. In its 2001-02 session, the Legislature considered several pieces of legislation that would have added to enforcement efforts, increased penalties for tax evasion, as well as several other similar measures. In addition, in recent past years the BOE itself has considered and approved proposals to reallocate resources

to cigarette and tobacco tax enforcement and investigations. Specially, some of the legislative and BOE proposals would have:

- Required the licensing of cigarette sellers.
- Imposed additional penalties for the illegal sale of cigarettes.
- Granted limited peace officer status to specified BOE inspectors.
- Imposed specified punishment for selling, possessing, or buying counterfeit stamps.
- Increased funding for additional investigators and other enforcement personnel.
- Required manufacturers rather than distributors to affix tax stamp indicia.

Will Revenues Go "Up in Smoke" Without Additional Resources? Estimates of current cigarette tax evasion activity represent considerable revenue losses to the state. Because roughly 90 percent of the excise taxes raised go to special funds, such evasion has a comparatively minor direct impact on the General Fund. However, such evasion can also affect the SUT (which goes to the General Fund), and could have indirect impacts on the General Fund in the form of pressure for increased support in the event that excise tax revenues erode. In addition, should additional cigarette taxes be approved as part of the 2003-04 budget, the impacts on the ESLRF (where the Governor's proposal dedicates these revenues) could be significant, as we have noted previously.

In the 2002-03 budget, the Legislature approved supplemental report language (SRL) requesting that the BOE provide a report to the Legislature containing the following information with respect to its enforcement activities:

- A description of the methodology and approach used in allocating investigations resources.
- Actual and estimated data regarding the number of investigations cases, workload, and related revenues.
- Data regarding additional investigations workload that is currently unfunded.

A draft of the SRL report has been received by the Legislature; however the level of detail provided in the report is not sufficient to provide a basis for a full analysis of the revenue likely to result from an increase in investigation resources or the reallocation of existing resources to this end. Partially, this is due to the difficulty in determining the additional compliance that results from additional enforcement. However, there may

be additional information in this area available from the BOE based on recent changes in taxes in other states and their related enforcement activities.

Legislative Analyst's Recommendation: Require BOE to Report at Hearings Regarding Additional Enforcement Policies. We recommend that the Legislature require BOE to report on the effectiveness of additional investigations programs or enforcement policies in order to reduce the amount of cigarette tax evasion. These additional activities may require new funding or the redirection of existing resources. Specifically, we recommend that BOE assess and report at hearings the following:

- Effectiveness of increasing investigations activity in terms of additional direct revenue, as well as the effect on overall compliance from such activity.
- Effectiveness of participating with other states or federal authorities in border enforcement activities.
- Effectiveness of increased penalties for cigarette smuggling and related tax evasion activities.

SECRETARY OF STATE
(0890)

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

The budget proposes total expenditures of $69.7 million for the SOS in 2003-04—a slight increase from the current year. Expenditures total $27.1 million from the General Fund, $32.9 million from the Business Fees Fund, and $8.8 million from reimbursements.

Funding for Vacant Positions Not Justified

The budget proposes to augment the Secretary of State's budget by $200,000 to restore funding eliminated in the current year as part of the effort to eliminate vacant positions in state government. We recommend denying the request since no workload data have been provided. (Reduce Item 0890-001-0228 by $200,000.)

Vacant Positions Eliminated Consistent With Legislative Direction. As part of the statewide process to eliminate 6,000 vacant positions in the current year, the Department of Finance (DOF)—pursuant to Control Section 31.60—eliminated 24 positions and $1.3 million dollars from the SOS's budget. Of this amount, 19 positions and $1 million were associated with the Business Fees Fund. Pursuant to Control Section 31.70, DOF restored $510,000 to the SOS's budget in the Business Fees Fund (the maximum restoration allowable by the control section). According to DOF, the funding was restored because the positions are associated with a revenue-raising fund.

Request for Additional Augmentation. The Governor's budget maintains the $510,000 restoration in the budget year. Furthermore, the budget proposes an additional $200,000 increase.

No Justification for Additional Funding. The SOS has not provided any workload information supporting the need for the $200,000 augmentation. Moreover, it is unclear for what specific purpose the funding would be used. Consequently, we recommend denying the request for the $200,000 augmentation. Since any balance in the Business Fees Fund at the end of the year is transferred to the General Fund, this action would result in an equivalent benefit to the General Fund.

Set Fee Equal to Costs

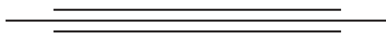
The Secretary of State proposes setting a filing fee on common interest development associations at $30. Since only minor increased costs have been identified, we recommend that the fee be set at $5 for the budget year through the adoption of budget bill language.

New Legislation Requires Increased Association Filings. There are estimated to be more than 30,000 common interest development (CID) associations (such as condominium associations) in California. Chapter 1117, Statutes of 2002 (AB 643, Lowenthal), requires all CID associations to biennially file basic information with the SOS's office (such as address and contact information). The intent of Chapter 1117 is to gain a better understanding of the type and number of CID associations in the state.

Fee Set at Maximum Level. To cover the Secretary's costs associated with the new filings, Chapter 1117 authorizes a filing fee to be charged to associations of *up to* $30. The SOS has chosen to impose the maximum $30 fee for the initial filings. At the $30 level, the fee is expected to generate $450,000 in 2003-04.

Minimal Costs Identified. While the SOS asserts that $30 is the incremental cost of processing one filing, the budget proposes only $61,000 in expenditures related to the filings. Specifically, the budget requests the funds for increased mailing costs and one position to maintain a database of filers' information. While the identified costs seem reasonable, the SOS has been unable to identify any other costs associated with Chapter 1117.

Recommend Reduced Fee. Since only $61,000 in new costs have been identified, we recommend that the Legislature, through budget bill language, limit the fee in 2003-04 to generate a comparable level of revenues. A fee of $5 would generate an estimated $75,000 and, therefore, provide the SOS with sufficient revenues to cover any other incidental costs above those already identified.



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 and Corporation Tax laws. The FTB also administers the Homeowners' and Renters' Assistance Program (HRA), the Political Reform Act audit program, and the Household and Dependent Care Expense Credit (HDCEC) program. In addition, FTB administers several nontax programs, including collection of child-support 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 FTB.

The Governor's budget proposes $445 million ($403 million General Fund) and 5,914 positions in support of FTB's operations. The total amount of support represents a decline of $17 million, or 3.7 percent, from the current year. General Fund support for FTB would decline by $15 million. The largest areas of reductions in the budget are (1) $11.8 million in reductions from the completion of the Integrated Nonfiler Compliance Project; (2) savings of $1.4 million from mandatory E-filing for certain tax practitioners; and (3) $1.5 million in reductions due to decreased outreach activities, program savings, and out-of-state travel restrictions. On the other hand, the budget proposes increases for workload associated with withholding on real estate sales of nonresidential property.

Increase Tax Practitioner E-Filing

We recommend that the budget proposal requiring E-filing for all tax practitioners filing 100 or more returns be expanded to require E-filing for all those filing 50 or more returns. (Reduce Item 1730-001-0001 by $140,000.) We also recommend that the Franchise Tax Board (FTB) charge tax practitioners for the use of the hotline maintained and staffed by FTB at the expense of taxpayers in general. (Reduce Item 1730-001-0001 by $1 million.)

E-Filing Proposal Should Be Expanded. Under the administration's E-filing proposal, tax practitioners who file 100 of more tax returns will be required to E-file or face a fine of $50 per return. The FTB estimates that the annual savings from this requirement would be approximately $1.4 million (51 PYs). Reducing the E-filing threshold to 50 or more returns would result in an additional annual savings of $140,000 (5.5 personnel-years).

Currently, the level of E-filing has leveled out, after a number of years of rapid growth. Mandatory E-filing by tax practitioners is one major means by which to expand the level of tax E-filing, thereby achieving considerable administrative savings. The FTB indicates that the reduction in the threshold from 100 to 50 tax filings would result in increased gross savings in excess of $400,000, but net savings of only $140,000, due the expected increase in taxpayers assistance costs associated with additional E-filers. Nevertheless, we recommend that the Legislature approve the lower threshold for two primary reasons:

- Additional E-filing by tax preparers is consistent with FTB's long-term goal of expanding the overall E-filing program.
- Additional costs associated with taxpayer assistance will decrease in future years as tax practitioners become familiar with the E-filing program.

Tax Practitioners Should Be Charged for Special Services. The FTB operates a number of taxpayer assistance programs. For example, individual taxpayers may call the department's call center for individual assistance. The call center receives between 2.5 million and 3 million calls per year. Tax practitioners receive a higher level of service than do individual taxpayers through the tax practitioner's hotline as part of FTB's Tax Practitioner Support Team (TPST). This service offers free technical advice to attorneys, enrolled tax agents, and certified public accounts.

The FTB spends approximately $1 million (12.5 PYs) on the tax practitioner's hotline, which handles about 200,000 calls annually. We think that the activities carried-out by the TPST constitute specialize business advice that is not available to taxpayers in general. Consequently, these activities should be considered a "cost of doing business'" and as a result, should appropriately be borne by the businesses receiving them. We therefore recommend that businesses availing themselves of these services be charged for them.

The FTB has indicated that a charge *per call* would not be an option without investing in a more complex and expensive telephone infrastructure. On the other hand, an *annual fee* charged to each tax practitioner for a certain amount of use would be an alternative, according to the depart-

ment. We therefore recommend that the department explore further the feasibility of this option and report its findings at budget hearings, including an estimate of the appropriate per-practitioner fee and the means by which to assess it.

Nonfiler Program Threshold Should Be Lowered

We recommend that the Legislature augment the budget in order to expand the integrated nonfiler compliance (INC) program, which would lead to increased revenues of $4.4 million. (Augment Item 1730-001-0001 by $800,000 for 14 positions and recognize an additional $4.4 million in revenues.)

The INC Program Helps Ensure Tax Compliance. The overall objective of FTB's non-filer compliance program is to ensure that businesses and individuals required to file tax returns in California carry out this obligation. The FTB's program uses a variety of automated and manual processes to achieve tax compliance from nonfilers. The INC program is part of this larger nonfiler compliance program operated by FTB. As part of this program, FTB receives federal tax returns from the Internal Revenue Service (IRS) for the last three years, wage information from the Employment Development Department, as well as various other data. By analyzing these data in an automated fashion, FTB can determine whether the records from these sources indicate that a federal return was filed or income was earned, and yet no state income tax return was filed.

Program Has Recently Been Improved. The FTB has recently completed improvements to its nonfiler compliance program, resulting in cost savings and greater efficiencies. The new system will allow for the integration of more data into the system and lead to the identification of an additional 100,000 non-filers. The program is also expected to reduce unnecessary taxpayer intrusion by reducing the number of erroneous notices, assessments, and collection actions which have occurred in the past as a result of incomplete or inaccurate data.

Current Program Should Be Expanded. Currently, once a nonfiler has been identified and the data indicate that a tax liability of at least $200 is owed, the nonfiler is sent correspondence from FTB about the need to file. We recommend lowering the threshold from $200 to $100, which would result in FTB contacting an estimated 120,000 additional nonfilers. The nonfilers would be sent a series of communications until payment is made or alternative arrangements are made with the FTB. The FTB estimates that these additional contacts would generate an addition $4.4 million in 2003-04. The overall cost of the expanded program is $800,000, resulting in a benefit-cost ratio in excess of 5:1. At this point, FTB has

indicated that a lower threshold than $100 would only be marginally effective.

LAO Recommendation. Given the state's fiscal position currently, we recommend that the Legislature provide additional funding to FTB in the amount of $800,000, in order to expand the INC program and recognize an addition $4.4 million General Fund revenue in the budget year.

FTB Should Revisit the Treasury Offset Program

We recommend that the Franchise Tax Board report at budget hearings regarding the feasibility and cost-effectiveness of participating in the existing Treasury Offset Program in order to reduce tax collection costs and increase revenues to the General Fund.

Background. Federal law provides for the collection of various past due liabilities owed the state—including state tax obligations—by the federal government through the reduction in the amount of refunds payable to federal taxpayers. In return, the federal government requires states to offset against state tax refunds certain federal obligations. Currently, 25 states participate in the Treasury Offset Program (TOP) and have reciprocal arrangements with the IRS with respect to tax delinquencies.

California Does Not Currently Participate. The FTB performed a study in 1998 to determine whether California's participation in TOP would be effective for California's tax collection programs. The FTB determined that participation was not effective for the following principal reasons:

- The most appropriate application of TOP was to nonresidents, yet this was prohibited under the program.
- A significant portion of the balance due the taxpayer was already being offset by other obligations that are collected first (for example, child support).
- Various procedural requirements—such as sending a certified letter of intent to all taxpayers possibly (but not necessarily) subject to the offset—added to the expense of the program.

In sum, FTB concluded the program at that time was not cost-effective for California and that it was receiving better results from its existing collection activities than would be available through the TOP.

Given the current level of participation by other states and the program experience that accompanies this level of participation, it may be that the existing program would now be suitable for California's participation. This could allow the state to reduce the amount of resources de-

voted to tax collections and maintain (or even enhance) its existing revenue stream. In view of this, we recommend that the FTB report at budget hearings on the existing requirements imposed on states to participate in the TOP, the effectiveness that the program has been able to achieve since it was established, and whether the program would benefit California at this time.

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.

The Governor's budget proposes total expenditures of $837 million from various funds (including $3 million from the General Fund) to support the DGS activities in 2003-04. This is a General Fund decrease of $14 million, or 82 percent, below estimated current-year expenditures due to a shift of costs to the Service Revolving Fund. Expenditures for building regulation and statewide support services are $396 million in the budget year, which represents a decrease of $22 million, or almost 5 percent, below estimated current-year expenditures.

Withhold Recommendation on Employee Parking Lot

We withhold recommendation on the expenditure authority increase of $233,000 for the lease costs of employee parking lots pending the outcome of the administration's request for a federal waiver of leasing highway rights-of-way at fair market value.

The budget proposes an increase in expenditure authority of $233,000 for the Motor Vehicle Parking Fund (MVPF). The purpose of the request is to (1) lease a parking lot for the tenants of the East End Project in downtown Sacramento and (2) pay for proposed increases in lease costs of some state parking lots.

Parking Lots Leased From the Department of Transportation (Caltrans). The DGS leases several parking lots on highway rights-of-way owned by Caltrans. Based on federal regulations, Caltrans must lease these lands at fair market value. According to the Department of Finance

(DOF), DGS has not been leasing these lands at fair market value and, therefore, the state may be in violation of federal regulations.

Administration Requesting Waiver of Federal Regulations. According to DOF, Caltrans is requesting a waiver of the fair market value lease requirement. If the federal government approves the waiver, the need for an expenditure authority increase would be reduced. For this reason, we withhold our recommendation of this request, pending the outcome of the administration's waiver request.

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 $16 million for SPB support in 2003-04, which is $3.4 million, or 17 percent, below current-year estimated expenditures. The proposed expenditures consist of $3 million from the General Fund and $13 million in reimbursements from state departments and other government entities. This reduction is due to the proposal to cut SPB's General Fund support by more than half (discussed below).

No Information on Proposed General Fund Cut

We withhold recommendation on the requested reduction of $3.8 million General Fund and 57 positions, pending receipt of detailed information on the proposed cuts.

The Governor's budget proposes a reduction of $3.8 million General Fund and 57 positions for SPB. This would result in a 53 percent decline

in General Fund support from the current year, leaving $3.1 million for the budget year. Activities funded by reimbursements would be unaffected. The budget notes that General Fund support for the following SPB functions would be retained:

- Hearing appeals of disciplinary actions, as prescribed in the State Constitution.
- Developing exams for the civil service hiring process.
- Providing advice and assistance related to the Dymally-Alatorre Bilingual Services Act, which sets standards for access to state services by non-English-speaking persons.

At the time of our analysis, we did not have any specific information on the nature or allocation of the total proposed reduction. For example, we do not know the impact of these reductions on other SPB functions, some of which are also specified in the Constitution. Such duties include (1) enforcing laws that govern the civil service system, (2) adopting classifications that spell out qualifications for and duties of positions in state government, and (3) hearing various nondisciplinary appeals. Consequently, we withhold recommendation on this proposal, pending receipt of detailed information on the proposed cuts.

HOUSING AND COMMUNITY DEVELOPMENT (2240)

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

The budget proposes expenditures of $651 million for 2003-04. Spending related to the passage of the Proposition 46 housing bond in November 2002 accounts for nearly $500 million of this amount. (Please see our analysis of the implementation of the housing bond in the "Crosscutting Issues" section of this chapter.) The proposed General Fund expenditures of $13 million—largely for emergency shelter assistance and the operation of migrant farmworker housing—is a 12 percent decrease from the current year. Federal funds account for $124 million of the proposed budget-year expenditures, primarily for the Community Development Block Grant and Home Investment Partnership Act programs. Special funds provide the remainder of the department's expenditures. The department has a proposed staffing level of 507 personnel-years.

MANDATE FOR REGIONAL PLANNING NEEDS LEGISLATIVE CHANGES

As part of its general plan, every city and county is required to prepare a "housing element" which assesses the conditions of its housing stock and outlines a five-year plan for housing development. Unlike other components of a local government's general plan, the housing element must be approved by the state—an activity performed by HCD. Despite the legal requirement of having a housing element in compliance with state law, only 56 percent of local governments currently meet this obligation.

Proposal to Defer Costs for Mandate

Mandate for Regional Planning. Chapter 1143, Statutes of 1980 (AB 2853, Roos), significantly expanded the requirements of local housing elements by requiring additional analysis of local housing needs, particularly in relation to housing by income group. Each community is assigned numeric housing development goals by income (that community's "fair share" of housing) through a process administered by regional councils of government (COGs).

Chapter 1143 was passed after the constitutional amendment which requires mandate reimbursements for state-required activities. The state, therefore, is required to reimburse local governments for the cost of the implementation of this regional planning mandate. (The state does not pay for other portions of the housing element process in place prior to Chapter 1143.) Specifically, the state is required to pay COGs, cities, and counties for the following expenses:

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

Governor Proposes Deferring Reimbursements Again. As with other mandates, the *2002-03 Budget Act* appropriated only $1,000 for the regional planning mandate—in effect deferring (with interest) the costs of reimbursements to local governments. For 2003-04, the Governor proposes to again defer these payments. During this deferment, local governments are still required to follow the statutory requirements, and the state continues to accumulate a financial liability for the mandated costs.

Costs Much Greater Than Budgeted. Because the state provides revised housing data to regions on a five-year rotating basis, not all local governments incur mandate costs in any given year. Prior to the 2002-03 budget, recent annual budgets provided less than $1 million for the costs of reimbursing local governments for this mandate. Yet, the annual costs associated with the mandate have been significantly greater than those budgeted amounts. For instance, from 1998-99 through 2001-02, a total of $3.5 million was appropriated through the budget bills for mandate reimbursements. To date, $9.9 million in claims have already been submitted for reimbursement for those years. In other words, the costs for the allocation process have been about *three times* the amount that the Legislature expected. If the Legislature were to again defer the payment of this

mandate, we estimate the state would have a future liability of more than $5 million combined for the two years of deferment.

City and County Mandate Does Not Lead To Housing Element Compliance

Cities and counties have broad discretion to interpret what level of effort is required by the regional planning mandate. As a result, claim costs vary tremendously by jurisdiction. Moreover, the mandate does not ensure compliance with state housing element requirements. Consequently, we recommend eliminating the mandate for cities and counties.

Majority of Mandate Costs for Cities and Counties. It is commonly assumed that the regional planning mandate costs are primarily for reimbursing COGs for their work in allocating housing numbers. Our review of submitted mandate claims, however, found that about 75 percent of the costs are associated with claims from cities and counties.

Tremendous Variation in Claim Costs. Since eligible costs for reimbursement relate to the collection, tabulation, and analysis of data, local governments have broad discretion as to what level of effort is appropriate under Chapter 1143. In our review, we found that the amounts of the claims vary tremendously—even for claims from similarly sized jurisdictions. For instance, the City of Corona in Riverside County submitted claims totaling about $13,000 over a two-year period, but the City of Moreno Valley (a similarly sized city also in Riverside County) submitted claims of about $265,000—*20 times* the amount of Corona's claims.

High Claims Do Not Lead to City and County Compliance. Spending time and money on mandated activities does not guarantee an increased number of state-approved housing elements. Jurisdictions can still seek reimbursements even if they fail to bring their housing elements into compliance with state law. For example, Corona's housing element is currently in compliance with state law, but Moreno Valley's element is out of compliance—despite Moreno Valley spending much more on mandated activities.

Recommend Eliminating Mandate on Cities and Counties. Since it provides broad discretion for levels of effort and does not guarantee compliance with state law, we conclude that the mandate on cities and counties is not worth the roughly $2 million annual cost—whether paid now or deferred to a later date. We, therefore, recommend that the Legislature enact legislation deleting the regional planning mandate for cities and counties. While some specific requirements of current law would be eliminated, cities and counties would still be required to adopt a state-approved housing element which addresses community housing needs.

Wait for Reform—Suspend Mandate for Regional Governments

The regional housing planning process is not very effective at ensuring the construction of affordable housing or obtaining compliance with state law. As a result, we recommend that the regional planning mandate for councils of government be suspended, pending the enactment of reforms to the process.

Concept for Oversight Has Merit. We believe that housing elements and the regional needs allocation process have merit in concept. They provide the state the opportunity to offer guidance on housing policy, while allowing local governments the flexibility to address their housing needs based on local conditions. The COGs play an important role in providing a regional perspective to this planning process.

Process Needs Improvement. At the same time, the current process is not very effective. Almost half of communities are not in compliance with state law, and some communities do not make an effort to obtain compliance. There are few incentives or sanctions to encourage local government compliance and accountability. Moreover, in its current form, the process is only a planning exercise. Little follow-up effort is made to ensure that the plans are followed and affordable housing is actually built. Last year, the Legislature attempted to address some of these problems in its discussions regarding SB 910 (Dunn), but no reform proposal was enacted.

Recommend Suspending Mandate on Regional Governments. At the conclusion of the 2002-03 housing needs allocation process, all regions will have completed an update in the past five years. Given the significant shortcomings of the process, we do not believe it is worth beginning another cycle of revisions under the current system. Instead, we recommend that the Legislature suspend the regional planning mandate for COGs and pursue legislative reforms of the process. Once the process undergoes significant improvements, the fair share allocation process could be reinstated. During the suspension, the state would avoid annual mandate liabilities of about $700,000.

To suspend this mandate, the Legislature would need to amend the budget bill to show a $0 appropriation (Item 2240-295-0001) and replace mandate budget provisions (1) and (2) with the following:

> Pursuant to Section 17581 of the Government Code, mandates identified in the appropriation schedule of this item with an appropriation of $0 and included in the language of this provision are specifically identified by the Legislature for suspension during the 2003-04 fiscal year: (1) Regional Housing Needs Assessment (Ch 1143, Stats. 1980).

STEPHEN P. TEALE DATA CENTER
(2780)

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

The budget proposes $93 million from the TDC Revolving Fund for support of the department in the budget year. This is an increase of $2.9 million, or 3 percent, above estimated current-year expenditures. The budget includes a number of increases for workload—the largest of which is a request for $4.3 million to upgrade mainframe computer systems.

Reduce Equipment Increase Proposal and Direct Data Center to Report on Actions to Reduce Costs and Rates

The Stephen P. Teale Data Center (TDC) requests an expenditure authority increase of $8.1 million to upgrade or purchase additional computer and network equipment. We recommend the Legislature reduce the proposal by $6.9 million since the method used to develop the proposal is based on past workload growth trends that are not reflective of 2003-04 demand for services. We further recommend that the data center report at budget hearings on actions that it could take which would lower both costs and rates charged to departments in the budget year. (Reduce Item 2780-001-0683 by $6.9 million.)

The budget proposes an increase in expenditure authority of $8.1 million to upgrade or purchase additional computer and network equipment.

Most of Request Based on Past Workload Growth Trends. The TDC states the increases are needed based on workload growth and new state IT projects. Of the $8.1 million being requested, we found that only $1.2 million was directly related to new projects (those being implemented by the Board of Equalization and the Department of Motor Vehicles). The

remaining $6.9 million reflects the data center's growth projections based on historical patterns. In the late 1990s, workload growth trends were an adequate measure to estimate data center funding needs because government services and spending were consistently increasing. With the severe budget problem, however, departments are experiencing reduced budgets and service levels. This means that departments' computing needs are also likely to be declining. As a result, the data center's use of historical workload growth measures appears to seriously *overstate* budget-year demand for its services. Accordingly, we recommend the Legislature reduce TDC's augmentation proposal by $6.9 million.

TDC to Report on Efforts to Lower Costs and Rates. With significant budget reductions expected in 2002-03 and 2003-04, departments will have limited budget flexibility and capability to pay for services. Consequently, it is important for service entities such as TDC—whose budget is based on reimbursements from other departments—to be holding the line or even decreasing its expenditures and rates. For example, the Department of General Services (DGS)—another entity whose budget is based on reimbursements—proposes to *decrease* its expenditure authority by almost $17 million and 23 positions to reflect proposed fee reductions. The DGS will pursue internal efficiencies to reduce its service fees and help departments reduce their costs.

The TDC has not followed the approach of DGS. With the exception of current-year reductions related to the statewide elimination of vacant positions and its annual budget adjustment for completed projects, TDC does not propose to reduce its expenditure authority. The TDC also does not propose to reduce the rates that it charges departments. We believe the data center should follow DGS' lead in pursing internal efficiencies to lower costs charged to departments. Accordingly, we recommend that TDC report at budget hearings on actions it has taken or will take to reduce its costs and lower its rates. This approach would lower departments' expenditures for TDC services and allow them to better adapt to their own reduced budgets.

Additional Positions for California Home Page Not Justified

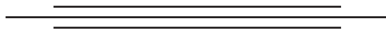
The Stephen P. Teale Data Center (TDC) requests an expenditure authority increase of $2.1 million and ten positions for the continued support and maintenance of the California Home Page and the Governor's E-mail system. We recommend the Legislature reduce the proposal by $453,000 and five positions since TDC is unable to provide data supporting the need for the additional positions.

The budget proposes an increase in expenditure authority of $2.1 million and ten positions for the continued support and maintenance of the

California Home Page and the Governor's E-mail system. The *2002-03 Budget Act* provided DGS with the primary responsibility for the ongoing support of the Home Page. In September 2002, the Department of Finance (DOF) notified the Legislature of the administration's intent to transfer the Home Page from DGS to TDC. In addition, DOF requested additional funding and positions to support the Home Page. To fund the increase, the request proposed to charge departments, depending on their size, a subscription rate to reflect their share of the cost to operate the Home Page.

In November 2002, the Legislature approved a modified plan to transfer the Home Page from DGS to TDC. To cover the ongoing costs of the Home Page at its existing service level, the plan involved transferring funds and positions to TDC and authorizing a reduced subscription rate. The Governor's budget request includes funding for the 2003-04 costs of that plan and an additional $453,000 for five new positions.

Additional Positions Not Justified. The data center did not provide workload data supporting the need for additional positions. Consequently, we recommend the Legislature reduce the request by $453,000 and five positions. This action would maintain the plan approved by the Legislature in November 2002.



Technology, Trade, and Commerce Agency (2920)

The Technology, Trade, and Commerce Agency, created in 1992, is the state's primary economic development entity for promoting the establishment, retention, and expansion of business, employment, infrastructure, and international trade in California. It promotes tourism as well as foreign investment. The agency also has been designated as the entity leading the state's efforts in defense conversion.

Agency Budget Greatly Reduced Since 2001-02

The agency's 2003-04 proposed budget is substantially lower than in 2001-02. As displayed in Figure 1 (see next page), the Infrastructure Bank is the mainstay of agency spending, remaining fairly constant over the period. On the other hand, under the Governor's proposal, all other expenditures drop 70 percent (all funds). Below, we highlight the year-to-year reductions over this period.

Current-Year Reductions. The current-year budget included elimination of the agency's regional offices as well as grants for local defense adjustment, development of small business software applications, and rural E-commerce programs. In addition, the 2002-03 budget reduced spending for the foreign trade offices, consulting services for small manufacturers, and small business grants for product development and generating electricity from biomass. This resulted in a 15 percent decline in total expenditures (37 percent for General Fund-supported activities) from 2001-02 to the current year.

Proposed Budget-Year Reductions. The administration proposes further reductions in 2003-04 from (1) substantially reducing most General Fund support and (2) eliminating consulting and technology grants for small businesses, defense retention activities, marketing and communications, economic research, and state-funded tourism promotion. This

Figure 1

Technology, Trade, and Commerce Agency Expenditures (All Funds)

(In Thousands)

	2001-02	Estimated 2002-03	Proposed 2003-04
Infrastructure bank	$81,311	$77,680	$76,182
Science, technology, and innovation programs	17,962	6,502	131
Film Commission and Film California First program	12,920	10,972	11,212
Biomass-to-energy grant program	11,500	—	—
Tourism	8,257	8,141	—
Manufacturing Technology Program	6,039	2,739	—
California Technology Investment Partnership and regional technology alliances	6,000	3,000	—
Foreign trade offices	5,584	3,915	3,361
Small business loan guarantee program	4,662	4,662	4,662
Regional offices	2,622	—	—
Internet network grants	2,000	—	—
Rural E-commerce grants	2,000	—	—
Office of Military Base Reuse and Retention	1,926	923	—
Economic research	1,217	883	188
Contract, grant, and loan administration	1,437	1,400	364
Marketing and communications	804	453	—
Commission of the Californias	324	278	280
Office of California-Mexico Affairs	250	241	242
Remainder	17,309	34,623	11,966
Totals	**$184,124**	**$156,412**	**$108,588**

amounts to a 31 percent reduction from total current-year spending (53 percent for the General Fund).

Special Fund Local Assistance Spared the Deepest Cuts. Most of the decline in agency spending is due to General Fund reductions—actions designed to address the state's fiscal shortfall. The proposed budget maintains special fund local assistance of $87 million in 2003-04—$76 million from the Infrastructure Bank, which provides low-interest loans to local governments for infrastructure projects. The remaining special fund local assistance (which also includes support from some federal funds) is for various grant and loan programs such as replacement of underground gasoline storage tanks, rural economic development, and disaster assistance.

WHAT GENERAL FUND SUPPORT REMAINS?

The reductions proposed by the administration leave General Fund support for the programs shown in Figure 2. The budget proposes $21 million for these purposes in 2003-04. This request preserves small business loan guarantees, film permit subsidies, and foreign trade offices at or near current-year levels. Below, we raise concerns regarding the effectiveness of film permit subsidies and the state's trade offices in particular.

Figure 2

2003-04 Proposed General Fund Expenditures

(In Thousands)

Film California First program	$8,200
Small business loan guarantee program	4,662
Foreign trade offices	3,361
Film Commission	2,992
Commission of the Californias	280
Office of California-Mexico Affairs	242
Other	1,706
Total	**$21,443**

Film Permit Subsidy Program

We recommend elimination of the film permit subsidy program and three related positions in the Film Commission because the program has an unclear rationale and a questionable impact on film location decisions. We further recommend that remaining monies in the fund be reverted. (Reduce Item 2920-111-0001 by $8.2 million and Item 2920-001-0001 by $0.3 million. Revert $2 million in Item 2920-101-3005.)

Started in 2000-01, the Film California First program subsidizes filming-related fees that movie and television production crews pay to local and other levels of governments for on-site filming in California. Reimbursements are capped at $300,000 per project (with some costs also capped on a per-day basis) and cover costs such as public safety expenses and public property use fees. The program has provided approximately $8 million per year for this purpose. The Governor's budget proposes $8.2 million for 2003-04 to keep the program at the current-year level.

Unclear Program Rationale. It is not clear what the rationale is for this particular subsidy. These film-related fees are part of the cost of doing business, and we have no information suggesting that they are either inappropriate or unreasonably high in California. Furthermore, it is unclear why the state provides a subsidy to this particular industry, thereby favoring it over others.

Subsidy Covers a Fraction of a Percent of Total Film Costs. According to our analysis of 2001 program data on reimbursements and total reported filming costs, Film California First's reimbursements covered on average 0.2 percent of total production costs. Looking at feature films in particular, the program reimbursed 2.7 percent of total costs for productions under $100,000 and 0.1 percent of production costs for $50 million-plus blockbusters. Given this small share of production costs, it appears unlikely that the program would have a significant impact on retaining film productions in California. Currency exchange rates and labor cost differences would appear to have greater impacts on film location decisions.

Recommend Elimination of Program. Given these concerns, we recommend elimination of the program and three related positions in the Film Commission for $8.5 million in General Fund savings. Furthermore, over the course of the program's operation, there have been significant delays in the use of the program funds. As a result, we further recommend that the Legislature revert remaining monies in the fund (chiefly from the current-year appropriation). The agency can report at budget hearings on the amount of remaining funds, but we anticipate it would be in the range of $2 million.

Foreign Trade Offices

We recommend that the Legislature eliminate all trade offices—five contract offices and seven state-staffed foreign trade offices—because they have questionable effectiveness. (Reduce Item 2920-012-0001 by $3.4 million.)

Governor Proposes Continued Operation of All Trade Offices. The state operates trade offices in 12 locations around the world. Seven foreign trade offices are staffed by state employees, while five other offices are staffed by contracted consultants. Although the Governor originally proposed the closure of the contract offices effective January 1, 2003 as part of the mid-year spending reductions, the administration now supports the continued operation of all 12 offices. Figure 3 displays current-year and proposed budget-year funding for these offices.

Figure 3

Foreign Trade Offices

(In Thousands)

	2001-02	Estimated 2002-03	Proposed 2003-04
State-Staffed Foreign Trade Offices			
Mexico	$1,150	$760	$696
Hong Kong	829	590	538
Japan	787	696	636
United Kingdom	571	534	488
Germany	544	491	449
Taiwan	354	337	308
South Africa	353	267	246
Subtotals	($4,588)	($3,675)	($3,361)
Contract Foreign Trade Offices[a]			
Argentina	$265	$25	$40
Shanghai	256	140	140
Singapore	191	100	100
South Korea	185	150	136
Israel	99	65	64
Subtotals	($996)	($480)	($480)
Totals, all offices	**$5,584**	**$4,155**	**$3,841**

[a] The Governor has rescinded an earlier proposal that would have closed these offices effective January 1, 2003.

Offices Have Questionable Effectiveness. In our view, these offices have not demonstrated a clear impact on state exports or foreign investment in California. In past assessments, the agency has claimed that the offices have been cost-effective. In these assessments, however, the agency counted the entire value of export and foreign investment agreements in which they played some role as attributable to the offices' efforts—regardless of how much involvement the offices had. For instance, an office may only have provided a list of foreign companies potentially interested in a product developed by a California business. However, the agency counted the *total value* of a subsequent export agreement as attributable to the office's assistance.

Other Resources Exist. To the extent that companies cannot successfully transact business in foreign markets on their own, the federal government and local trade organizations generally provide opportunities

and assistance. As a result, we recommend that the Legislature eliminate all trade offices—five contract offices, as the administration originally proposed, and seven state-staffed foreign trade offices—for an additional savings of $3.4 million General Fund (less any shut-down costs).

Agency Size Warrants Department Status

We recommend that the Legislature adopt trailer bill language returning the agency to department status, given the agency's small size relative to the state's other agencies and its department-like duties.

As noted above, the agency was created in 1992. Previously, this entity had been the Department of Commerce in the Business, Transportation, and Housing Agency. Given recent sizeable cuts, we believe the agency's current-year budget—with an estimated $156 million in expenditures (including $78 million in loans from the Infrastructure Bank) and 259 personnel-years (PYs)—warrants a return to department status. The Governor's proposed reductions for 2003-04 would further reduce the agency's size to $109 million and 104 PYs. By comparison, with approximately 2,600 employees, the Labor and Workforce Development Agency has the fewest number of employees of the state's other agencies. In addition, the agency does not perform the same functions as other agencies, such as providing policy guidance to constituent departments. In this case, the agency does not oversee other departments.

Consequently, we recommend that the Legislature adopt trailer bill legislation that moves the agency back into the Business, Transportation, and Housing Agency as a department. We would expect some minor administrative efficiencies associated with department status, such as reduced executive salaries and overhead costs.

CALTIP GRANT PROGRAM NOT COST-EFFECTIVE

Grant Program for Technology Developed by Small Businesses

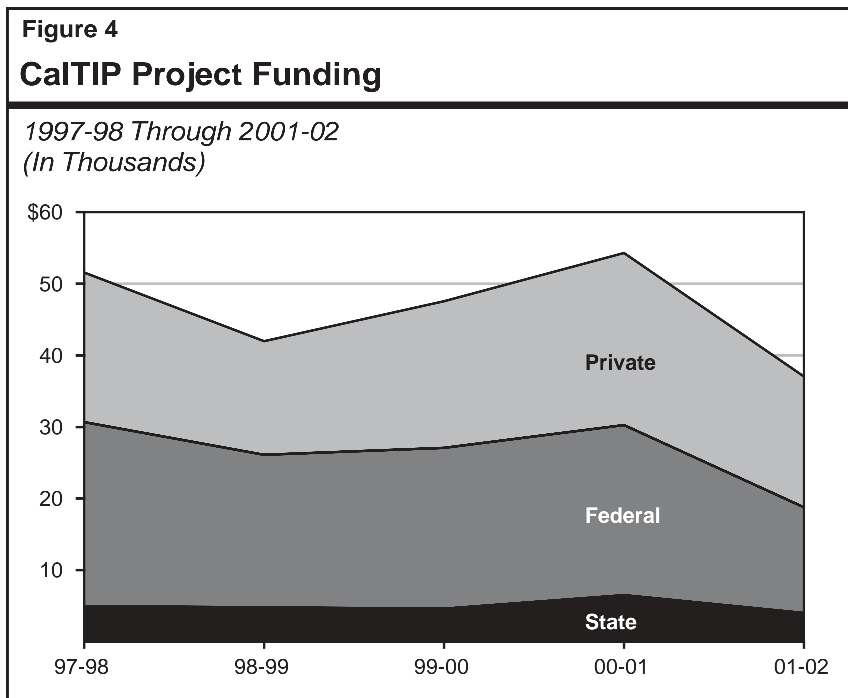
CalTIP Grants. Established in 1993-94, the California Technology Investment Partnership (CalTIP) program provides state funds to increase the speed of technologically innovative products development by small businesses. The grant program was designed to serve two primary purposes:

- Promote defense conversion by creating new jobs for defense workers affected by cutbacks in the early 1990s.
- Help secure federal research and development grants by providing state matching funds.

Recent projects have included lower-cost water purification, reducing computer network downtime due to crashes and upgrades, and developing a coating for commercial furnace tubes to improve heating.

State Program Supplements Existing Federal Funds. Federal funding drives the state's CalTIP program. That is, businesses must secure federal funding to receive a CalTIP grant. On the other hand, state funds are not required to receive federal funds.

From 1997-98 through 2001-02, $25 million from the General Fund has supported 145 CalTIP projects. The typical CalTIP award is about $200,000. Businesses awarded state funding have also received $108 million in federal grants and $100 million from private sources (including the businesses themselves) to support their projects—for a total of $233 million in project funding. Thus, on average, the state has provided 11 percent of funds, compared to 46 percent from the federal government and the remaining 43 percent from private funds. Figure 4 shows the funding split over the previous five years.



Program Administered by Regional Technology Alliances. The state created nonprofit regional technology alliances (RTAs) to administer the CalTIP grants and to support technology development and commercial-

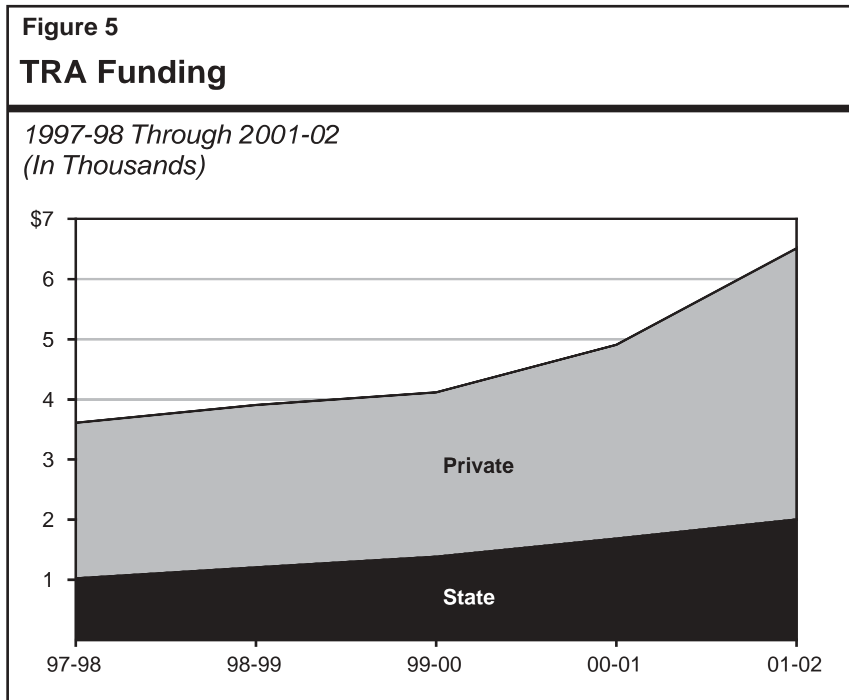
ization. Current law requires RTAs to raise funds from many sources, assist in the formation of new businesses, provide industry networking forums, and identify emerging industries. There are currently six RTAs serving San Diego, Los Angeles, the Bay Area, the Inland Empire, the San Joaquin Valley, and the Sacramento region.

From 1997-98 through 2001-02, RTAs received $7 million in state support and $16 million from private sponsors. In other words, the state has provided 32 percent of RTA funding on average, while private sources have provided the remaining 68 percent. Figure 5 shows the funding split over the previous five years.

Figure 5

TRA Funding

1997-98 Through 2001-02
(In Thousands)



Governor's Budget. The agency's current-year budget provides $1 million for CalTIP grants and $2 million to support activities of the six RTAs. However, the Governor's proposed 2003-04 budget eliminates funding for both the grants and the RTAs.

Survey Results

Recently, the agency surveyed 94 businesses that received CalTIP grants from 1993-94 to 1999-00 to assess the impact of the program. Fig-

ure 6 shows some of the survey questions and the responses. This survey provides data that we use below to evaluate the effectiveness of the program. Self-reported data carry an inherent risk that those surveyed will

Figure 6

Selected Questions From Agency's CalTIP Grant Survey[a]

	Percent
✓ Did the CalTIP-funded project result in the launch of a new product, service, or process?	
Yes	33%
No	67
✓ Was the CalTIP grant necessary for this project to occur?	
Yes	76
No	24
✓ Was the CalTIP grant needed to secure federal funds for this project?	
Yes	37
No	63
✓ Did your CalTIP award help you obtain capital from other sources?	
Yes	38
No	62
✓ How would the project have differed if no CalTIP funds had been awarded?	
Would have impeded development	46
Project would have died	31
Would have needed money from other sources	19
Little or no difference	4
	Jobs
✓ How many jobs did the CalTIP-funded product create in your company?	
Total jobs created	169

a Survey of 94 businesses.

report more favorable outcomes than is the case, thereby skewing results of program effectiveness. Even accepting this risk, the survey results discussed below demonstrate serious shortcomings with the CalTIP program.

Outcomes and Job Creation. As noted above, CalTIP grants are intended to support the commercialization of products that use new technologies. Two-thirds of grant recipients, however, did not get a new product to market as a result of the CalTIP projects. Across all surveyed companies, the total number of ongoing jobs created was 169, representing an average of under 2 jobs per company. For the one-third of recipients that did get their products to market, these businesses reported an average of about 5.5 new ongoing jobs within the company because of the new product. This means that on average companies without products did not generate any new project-related jobs.

What If CalTIP Grants Had Not Been Available? The agency also asked businesses if the CalTIP grant was necessary for the project to occur. Although three-quarters responded affirmatively, only 31 percent said their projects would have died without CalTIP funds. Nearly half said the lack of CalTIP funds would have hindered product development. At the same time though, more than 60 percent of businesses responded that they did not need CalTIP grants to get federal or private funds.

Has CalTIP Been Worth the Cost?

The agency often evaluates the effectiveness of a program by using estimates of jobs created or retained and tax revenue generated. But evaluating a program's effectiveness must also determine whether these benefits attributed to the program were worth the cost incurred to achieve them.

Reported Job Creation Small and Costly. As noted above, surveyed businesses reported fewer than two ongoing jobs created on average due to CalTIP-supported projects. (These jobs paid $63,525 annually on average.) Given that the typical CalTIP award has been about $200,000, this translates to the state paying around $100,000 for each project-related job created. With $400,000 each from the federal government and private investors and $100,000 from the state per job, *the typical CalTIP-related job has cost approximately $900,000 to create.*

State Not Responsible for All Job Creation. Because state funding represents a small portion of total support for projects awarded CalTIP grants, we do not believe the agency can attribute sole or even primary responsibility for the existence of these jobs to the program. In fact, as discussed previously, a majority of businesses indicated that their CalTIP grants were not critical for project development to continue or to get fed-

eral or private funding. Some portion, if not most, of these jobs, therefore, would have been created even absent state funds.

Tax Revenue Attributable to State Support Is Small. As an offset to the state costs identified above, the state receives some increased revenues from new product development and sales. As with job creation though, the agency could only attribute at most a small portion of this revenue to the state program. This is because of (1) the relatively small share of state funding and (2) the noncritical nature of CalTIP grants for securing the majority of funding or developing the products. Thus, based on survey data, we estimate that the actual annual "new" revenue to the state as a result of having the CalTIP grants is likely well under $1 million—a minimal amount compared to program spending. It would, therefore, take many years to recoup in tax revenues the funding provided for CalTIP grants to date.

Stated Purposes Not Clearly Met

The program began in part as a defense conversion effort to provide jobs for unemployed defense industry workers. The agency has not collected data on who recipient businesses hired to work on CalTIP-funded projects. So we cannot determine whether the program met this goal. At this point, however, the state is several years removed from the 1990s military base closures. The California economy and these workers probably have adjusted by now to those events (notwithstanding the current state of the economy, which arose from economic issues unrelated to the defense industry).

The other stated purpose of the grant program was to help secure federal research and development funding. Yet, as noted above, most businesses responded that their CalTIP grants were not critical factors in getting federal or private support.

CalTIP Is Not a Cost-Effective Use of General Fund Resources

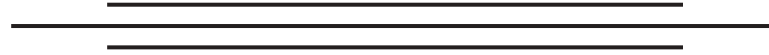
We recommend that the Legislature approve the proposed deletion of funding for CalTIP grants and the regional technology alliances (RTAs) in the 2003-04 budget. We further recommend enactment of legislation to eliminate the grant program and the RTAs as state-created entities because the program's job and tax revenue impact does not justify its state costs.

Based on this analysis of the agency's survey of recipient businesses, we conclude that the CalTIP grant program has not been a cost-effective use of General Fund resources to promote economic growth through job creation and product development. Our conclusion is primarily based on

three factors: (1) the high cost paid by the state per project-related position created, (2) the small amount of tax revenue (relative to program spending) the agency could reasonably attribute to the program, and (3) the program has not met its stated purposes.

With respect to the RTAs that administer the CalTIP program, a majority of their funding comes from private sources. In addition, many of their industry networking events are cosponsored with private organizations. It is not clear that state involvement significantly adds to the business opportunities afforded by the private marketplace.

Recommend Eliminating CalTIP and the RTAs. Consequently, we recommend that the Legislature approve the proposed deletion of funding for CalTIP and the RTAs in the 2003-04 budget. We further recommend enactment of legislation to eliminate the grant program and the RTAs as state-created entities. We believe this funding is better used to address the General Fund shortfall. The RTAs could continue to exist with the financial assistance of the private companies that currently support them, to the extent businesses find their services of value.



HEALTH AND HUMAN SERVICES AGENCY DATA CENTER (4130)

The Health and Human Services Agency Data Center (HHSDC) provides information technology (IT) services, including computer and communications network services, to the various departments within the Health and Human Services Agency. The center also provides services to other state entities and various local jurisdictions. The cost of the center's operations is fully reimbursed by its clients.

The budget proposes $332 million for support of the data center in 2003-04, which is an increase of $16 million, or 5 percent, above estimated current-year expenditures. The budget includes a number of increases for workload and the continued implementation of IT projects.

Deny Equipment Increase Proposal and Direct Data Center to Report On Actions to Reduce Costs and Rates

The Health and Human Services Agency Data Center requests an expenditure authority increase of $4.7 million and 15 positions to purchase computer equipment and develop rates for new data center services. Since none of this request relates to new projects, we recommend the Legislature deny the augmentation since the method used to develop the proposal is based on past workload growth trends that are not reflective of 2003-04 demand for services. We further recommend that the data center report at budget hearings on actions that it could take which would lower both costs and rates charged to departments in the budget year. (Reduce Item 4130-001-0683 by $4.7 million.)

The budget proposes an increase in expenditure authority of $4.7 million to purchase computer equipment and develop rates for new data center services.

Request Based on Past Workload Growth Trends. The HHSDC states the increases are needed based on workload growth and new state IT projects. The HHSDC, however, was unable to match proposed expenditure authority increases to specific department activities or projects. Instead, the $4.7 million and 15 positions reflect the data center's growth projections based on historical patterns. In the late 1990s, workload growth trends were an adequate measure to estimate data center funding needs because government services and spending were consistently increasing. With the severe budget problem, however, departments are experiencing reduced budgets and service levels. This means that departments' computing needs are also likely to be declining. As a result, the data center's use of historical workload growth measures appears to seriously *overstate* budget-year demand for its services. Accordingly, we recommend the Legislature reject HHSDC's augmentation proposal.

HHSDC to Report on Efforts to Lower Costs and Rates. With significant budget reductions expected in 2002-03 and 2003-04, departments will have limited budget flexibility and capability to pay for services. Consequently, it is important for service entities such as HHSDC—whose budget is based on reimbursements from other departments—to be holding the line or even decreasing its expenditures and rates. For example, the Department of General Services (DGS)—another entity whose budget is based on reimbursements—proposes to *decrease* its expenditure authority by almost $17 million and 23 positions to reflect proposed fee reductions. The DGS will pursue internal efficiencies to reduce its service fees and help departments reduce their costs.

The HHSDC has not followed the approach of DGS. With the exception of current-year reductions related to the statewide elimination of vacant positions and its annual budget adjustment for completed projects, HHSDC does not propose to reduce its expenditure authority. The HHSDC also does not propose to reduce the rates that it charges departments. Through the *Supplemental Report of the 2002 Budget Act*, the Legislature directed HHSDC to perform a study to identify HHSDC operations that should be improved and would result in reduced rates and costs. However, HHSDC informs us that it will not conduct the requested study because it did not receive additional funding to conduct it. Had the data center complied with legislative intent, it would be in a better position to reduce its costs and rates.

We believe the data center should follow DGS' lead in pursing internal efficiencies to lower costs charged to departments. Accordingly, we recommend that HHSDC report at budget hearings on actions it has taken or will take to reduce its costs and lower its rates. This approach would lower departments' expenditures for HHSDC services and allow them to better adapt to their own reduced budgets. In addition, we recommend

HHSDC report at hearings on why it did not conduct the study requested by the Legislature.

Deny Operational Recovery Proposal Due to Project Inconsistencies

The Health and Human Services Agency Data Center (HHSDC) requests an expenditure authority increase of $1.2 million to provide operational recovery services to the Employment Development Department and the Department of Developmental Services. Our review found that the budget request is inconsistent with the project's Feasibility Study Report, and HHSDC did not examine all viable options for these services. For these reasons, we recommend the Legislature deny the proposal. (Reduce Item 4130-001-0632 by $1.2 million.)

The budget requests an expenditure authority increase of $1.2 million to provide operational recovery support to computer systems used by the Employment Development Department (EDD) and the Department of Developmental Services (DDS).

HHSDC's Proposed Funding. Operational recovery allows computer systems that have suffered severe hardware or software failures to be "restored" or returned to normal operation within a few hours. The state has typically contracted for this service. The HHSDC proposes spending in the current and budget years $2 million to provide: (1) $744,000 to support EDD, (2) $120,000 to support DDS, (3) $915,000 for testing, and (4) $180,000 for unspecified consulting activities. The HHSDC currently has a baseline expenditure authority of $437,000 for such recovery activities, and it anticipates that $370,000 of the proposed activities will begin and be billed in the current year. After accounting for this $807,000 in existing resources, the budget proposes an augmentation of $1.2 million.

Request Is Inconsistent With Project Proposal. When a department proposes an IT project, state policy requires the department to prepare a Feasibility Study Report (FSR), which identifies the benefits for the state's investment in the project. The FSR also includes cost details to support any proposed budget request. According to the FSR supporting this request (submitted in November 2002), the data center will annually receive (1) $984,000 from EDD and (2) $240,000 from DDS to pay a contractor to perform operational recovery services. These amounts, however, are inconsistent with the amounts included in the budget request. In addition, the budget request includes $735,000 that is not included in the FSR. Since the FSR should include all project costs, it is unclear how the $735,000 relates to the proposed operational recovery services for EDD and DDS.

HHSDC Did Not Examine Services Available From Other State Data Centers. In reviewing the FSR, we also found that HHSDC did not examine the costs and benefits of having other state data centers perform these services instead of contractors. The state has other data centers—such as the Stephen P. Teale Data Center and the Department of Justice's Hawkins Data Center—that may be able to perform these activities at a lower cost.

Recommend Denying Request. Since (1) the budget request is inconsistent with the FSR and (2) HHSDC did not examine all viable alternatives for this request, we recommend the Legislature deny the proposal. The HHSDC could resubmit a request (1) after it has examined all viable operational recovery alternatives and (2) that contains costs for only EDD and DDS operational recovery needs.

Proposed Budget Bill Language Unnecessary

The Health and Human Services Agency Data Center (HHSDC) proposes budget bill language that authorizes the Department of Finance to increase HHSDC's expenditure authority to accommodate additional training requests. Since HHSDC already has similar budget bill language for unanticipated workload requests, we recommend the Legislature delete the proposed language.

The HHSDC proposes budget bill language that authorizes the Department of Finance (DOF) to increase HHSDC's expenditure authority during the budget year to accommodate additional training requests.

State IT Training Center. The HHSDC operates the state's IT training center used by both state and local governments. The HHSDC uses contractors to teach the training classes and only purchases contractor services after enough students have enrolled in the proposed classes. Based on past workload growth trends, HHSDC estimates that its current expenditure authority will be inadequate to meet the training needs of government agencies.

Current Budget Bill Language Provides Proposed Authority. The HHSDC already has budget bill language that authorizes DOF to increase its authority for unanticipated workload. If HHSDC is unable to meet its budget-year training needs with its existing expenditure authority, its current budget bill language provides the authority to address unanticipated workload growth. For this reason, we recommend the Legislature delete the proposed budget bill language.

Financing Available for Child Welfare Services Project

The Health and Human Services Agency Data Center (HHSDC) proposes to increase its expenditure authority by $30 million to upgrade hardware and software used to support the Child Welfare Services/Case Management System (CWS/CMS). Since interest costs would be reimbursed by the federal government, we recommend the Legislature (1) reduce the request by $11 million in hardware costs not proposed to be financed and (2) direct HHSDC to submit a revised request that includes financing of all hardware acquisitions. (Reduce Item 4130-0001-0632 by $11 million.)

The budget proposes to increase HHSDC's expenditure authority by $30 million to upgrade software and hardware used to support the Child Welfare Services/Case Management system (CWS/CMS). The CWS/CMS system provides a statewide database, case management tools, and reporting system for the state's CWS program. The project has completed development, and is now operational in all counties.

HHSDC Proposes Hardware and Software Upgrades. The proposal specifically requests (1) $13 million in additional costs to operate the system, (2) $11 million in new hardware, (3) $6.7 million in software upgrades, and (4) $218,000 for one additional position and HHSDC overhead. These costs are offset by $1.1 million in baseline reductions.

Hardware Purchases Should Be Financed. One of the methods that departments can use to reduce budget-year costs is to finance equipment purchases. Financing increases the overall cost of equipment because interest is an additional cost. For equipment purchased to support federally mandated programs, however, the federal government will reimburse the state for interest costs. The CWS program is a federally mandated program.

For this request, HHSDC proposes to finance only a $100,000 E-mail server. The other equipment (personal computers and telecommunications hardware) could also be financed. Financing all hardware purchases would significantly reduce the budget-year costs of this proposal. For this reason, we recommend the Legislature reduce the proposal by $11 million and direct HHSDC to submit a revised proposal that finances all proposed hardware purchases.

Data Center Should Examine Competitive Procurement

The Health and Human Services Agency Data Center (HHSDC) proposes to increase its expenditure authority by $4.7 million to develop the Child Welfare Services/Case Management System (CWS/CMS) Expanded Adoption Subsystem (EAS). The HHSDC intends to amend the current CWS/CMS contract for the development and implementation of EAS. Since a competitive procurement may result in lower costs, we recommend the Legislature adopt budget bill language directing HHSDC to examine competitive procurements options prior to amending the current CWS/CMS contract.

The budget proposes to increase HHSDC's expenditure authority by $4.7 million to develop the CWS/CMS Expanded Adoption Subsystem (EAS). The purpose of this federally and state-mandated system is to track and record adoption activities for foster care children.

History of Current CWS/CMS Contract. The CWS/CMS is maintained and operated by a contractor. In 1992, the original CWS/CMS contract was roughly $88 million, but it has since been amended several times. The contract, as a result, now has a total value of $400 million. The purpose of these amendments have been for hardware and software upgrades, increased maintenance and operation costs, and system enhancements. In 1997, state control agencies and the federal government directed HHSDC to conduct a competitive procurement for ongoing CWS/CMS maintenance and operation activities. In 2000, the state began this competitive procurement. The procurement was cancelled in 2002, however, since HHSDC was unable to address federal procurement requirements. The HHSDC intends to begin a new competitive procurement in 2004-05 in order to have a new contract in place in 2005-06.

Future CWS/CMS Activities Should Be Competitively Procured. The HHSDC intends to amend the current CWS/CMS contract to include the development and implementation of EAS. This action would result in a contract increase of $7 million. Our review of the Special Project Report submitted to the DOF in January 2003 found that HHSDC did not examine competitive procurement alternatives, where other contractors could bid to perform this development effort. A competitive procurement may result in lower budget-year contract costs. For these reasons, we recommend the Legislature adopt the following budget bill language:

> The Health and Human Services Agency Data Center shall examine competitive procurement options as directed by the Department of General Services and the federal government prior to amending the primary contract supporting the Child Welfare Services/Case Management System.

EMPLOYMENT DEVELOPMENT DEPARTMENT (7100)

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

In addition, the department collects taxes and pays benefits under the UI and DI programs. The department collects from employers (1) their UI contributions, (2) the Employment Training Tax, and (3) employee contributions for DI. It also collects personal income tax withholding. In addition, it pays UI and DI benefits to eligible claimants.

The budget proposes expenditures totaling $10.6 billion from all funds for support of EDD in 2003-04. This is a decrease $2.3 billion or 18 percent below current-year estimated expenditures. This decrease primarily results from the expectation that one-time unemployment insurance extended benefits costs incurred during 2002-03 will not occur in 2003-04. The budget proposes $21.6 million from the General Fund in 2003-04 which is a reduction of $1.3 million (5.9 percent) compared to the current year.

Workforce Investment Act Discretionary Funds

The Governor's budget proposes to use most of the available Workforce Investment Act (WIA) discretionary funds to support existing programs and the Nurses Workforce Initiative.

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

Pursuant to federal law, 85 percent of WIA funds (an estimated $542 million in 2003-04) are allocated to local WIBs, formerly known as Private Industry Councils. The remaining 15 percent of WIA funds ($81.3 million) is available for discretionary purposes such as administration, statewide initiatives, current employment service programs, or competitive grants. The budget anticipates that $10.9 in unspent funds from 2002-03 will be carried forward to 2003-04, raising the total discretionary funds to $92.2 million for the budget year.

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

Governor's Proposal. Based on information provided by EDD, Figure 1 shows the Governor's expenditure plan for state discretionary WIA funds. As the figure shows, $2.3 million is proposed for administration, $25.5 million is budgeted for required WIA activities, $11.7 million is for EDD local program services, and $52.7 million is dedicated to various proposed programs. The largest new program is the Nurses Workforce Initiative ($20 million). This is a multiyear program designed to increase the supply of nurses in the workforce through outreach, recruitment, and training activities. Most of the remaining funds would be used to offset General Fund costs in existing programs, backfill for reductions in other federal funding sources, or continue programs originally funded under the Job Training Partnership Act. Whether to continue any of these programs is a policy decision for the Legislature.

Figure 1

Workforce Investment Act State Discretionary Funds 2003-04 Proposed Expenditures

(In Millions)

Category	Amount
Administration	
Employment Development Department	$1.6
California Workforce Investment Board	0.7
Subtotal	($2.3)
Federally Required WIA Activities[a]	$25.5
EDD Local Program Services	$11.7
Proposed Programs	
• Nurses Workforce Initiative	$20.0
• Preventing Parolee Crime Program	10.6
• Los Angeles County Work Plan for Worker Retraining	8.0
• Governor's Award for Veteran's grants	6.0
• Community and Faith-Based Initiative	4.0
• Female Offenders Treatment and Employment Program	2.0
• Veterans/Disabled Veterans Employment Services	1.5
• Department of Education WIA Coordination/Program Integration	0.3
• Community Colleges WIA Coordination/Program Integration	0.3
Subtotal	($52.7)
Total proposed expenditures	**$92.2**

[a] Includes incentive grants, technical assistance grants, assistance to locals for eligible youth, fiscal and management information system needs, eligible training provider list, program improvement activities, and One-Stop system operating needs.

Reed Act Funds Available for Benefit Payments and Administrative Improvements

In April 2002, California received a distribution of Reed Act funds of $937 million. These funds may be used for unemployment insurance benefit claims, administrative expenses in the Job Services (JS) and Unemployment Insurance (UI) programs, capital outlay in JS and UI, and certain automation improvements. We review the expenditure plans for these funds.

***Background*.** Pursuant to the Federal Unemployment Tax Act (FUTA), employers pay 0.8 percent of the first $7,000 in wages for each employee in order to finance (1) the administration of the Unemployment Insur-

ance (UI) program, (2) reserves for extended benefits, and (3) state loan funds. (This tax is in addition to unemployment taxes that support benefit payments.) When reserves in the federal accounts for administration, extended benefits, and loans reach statutory caps, the excess is distributed to states based on their share of FUTA taxes paid. These payments are referred to as "Reed Act" distributions.

2002 Distribution. The Job Creation and Worker Assistance Act of 2002 (Public Law 107-147) authorized the distribution of $8 billion in Reed Act funds to the states. In April 2002, California received $936.9 million in these funds. Pursuant to federal law, Reed Act funds are deposited into the Unemployment Trust Fund.

Allowable Uses of Reed Act Funds. There are three primary uses for Reed Act funds. These are payment of UI benefits, administrative costs in the UI and JS programs, and capital expenditures for the UI and JS programs. Capital improvements can be financed with a Reed Act revolving fund, whereby the improvements are paid for up front with Reed Act funds, with the revolving fund being repaid over time. Once repaid, the funds can be used for additional capital improvements. Unless the Legislature specifically appropriates Reed Act funds toward other allowable uses, the funds remain in the Unemployment Trust Fund for purposes of paying UI benefits.

2002-03 Budget Proposals for Reed Act Funds. The Legislature adopted the Governor's May Revision proposal to use $39.1 million in Reed Act funds to support the JS program. This fund shift saved an identical amount of General Fund dollars. In addition, Chapter 4, Statutes of 2002 (SB 2xxx, Alarcón), set aside $600 million in Reed Act funds for the payment of UI benefits'.

Governor's Veto. The Legislature appropriated $140.7 million in Reed Act funds to support a variety automation and administrative improvements to the UI system. These included $100 million for updating EDD's single client database, $20 million for the administrative costs of creating an alternative base period for the UI program (this would have expanded UI eligibility), and $7 million to redesign the UI certification system so claimants could certify by phone or the Internet. The Governor vetoed all but $500,000 of these automation improvements. He sustained $500,000 for a review of the Employment Tax System. The Governor's veto message indicated that he may consider the other legislative automation proposals if feasibility study reports are developed.

2003-04 Budget Proposals. The Governor's budget proposes a total of $54 million in Reed Act expenditures. In general, the proposed expenditures are for existing activities, that would otherwise require General Fund support. These include Job Services and UI administration.

DEPARTMENT OF INDUSTRIAL RELATIONS (7350)

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

Budget Proposes Funding Switch for General Fund Savings. The Governor's budget proposes expenditures totaling $244 million for the department in 2003-04. This is 3.3 percent less than estimated expenditures for the current year. The request includes $63 million from the General Fund, 49 percent less than 2002-03 estimated expenditures. This is largely due to the proposed shift of all General Fund support for workers' compensation programs ($72 million) to employer assessments. These payments, which currently provide 20 percent of funding for workers' compensation programs, would have to be increased significantly. If the Legislature does not approve all or a portion of the Governor's proposed funding switch, a corresponding augmentation in General Fund support would be required.

BUDGET PROPOSAL FOR IMPLEMENTATION OF WORKERS' COMPENSATION PACKAGE

Background

Most businesses in California purchase workers' compensation insurance from private insurance companies or the State Compensation

Insurance Fund (a state-created entity that also provides workers' compensation coverage). Some large businesses and government entities are self-insured. Rather than purchasing insurance to cover these costs, these entities directly pay their workers' compensation liabilities.

The DIR administers state workers' compensation programs that (1) handle cases in which injured workers and insurance companies have not agreed on compensation for injuries and (2) oversee and analyze various aspects of the workers' compensation system. Most of this activity occurs in the Division of Workers' Compensation (DWC), which includes disability rating, claims audits, and the appeals hearing process. The Commission on Health and Safety and Workers' Compensation (CHSWC) and the Industrial Medical Council are involved as well. The budget proposes a total of $109 million for state workers' compensation programs in 2003-04. This includes $105 million from assessments on employers and insurance companies.

Workers' Compensation Legislation Approved in 2002. Chapter 6, Statutes of 2002 (AB 749, T. Calderon), increased disability benefit payments effective January 1, 2003, and adopted changes intended to reduce workers' compensation system costs. Chapter 6 also imposed additional requirements on DIR. In the *2002-03 Budget Act*, the Legislature augmented the department's budget by $6.9 million and 62 positions to implement these requirements. The Governor vetoed all of this augmentation except $1 million for workers' compensation insurance fraud activities. Subsequently, the Governor's Mid-Year Budget Proposal requested a one-time suspension of this funding to address the General Fund shortfall. (The department's budget includes this fraud component for 2003-04.)

Budget Request

Proposal Consistent With Chapter 6. For 2003-04, the budget proposes $9.3 million and 72 positions to implement provisions of Chapter 6. Overall, the request appears reasonable and consistent with these provisions. The positions requested mirror the legislative augmentation to a large degree. The key difference from the current-year legislative augmentation is an increase of approximately $2.4 million in consultant contracts for largely one-time activities required by Chapter 6.

Proposal Addresses System Savings and Anticipated Workload. The proposal, as detailed in Figure 1, addresses specific items in Chapter 6 designed to identify and/or capture savings from the workers' compensation system. In addition, the budget also requests additional positions for anticipated increases in workload due to the reform legislation. Specifically, the budget includes the following:

Figure 1

Proposal to Implement Workers' Compensation Package[a]

(Dollars in Thousands)

	Proposed		LAO Recommendation	
	Positions	**Amount**	**Positions**	**Amount**
Division of Workers' Compensation				
Eight additional "judge teams"	29.0	$2,509	29.0	$2,509
Audit and enforcement unit	14.0	1,265	14.0	1,265
Court administrator	6.0	616	6.0	616
Vocational rehabilitation workload	6.0	510	6.0	510[b]
Disability evaluations workload	4.5	330	4.5	330
Certification of additional health plans to provide workers' compensation-related treatment	3.5	301	3.5	301
Legal unit rulemaking and litigation workload	3.0	354	3.0	354
Establish medical unit to direct new medical-related responsibilities	1.0	208	1.0	208
Research unit analysis	1.0	101	1.0	101
Annual workers' compensation fraud notice[c]	—	377	—	377
Various contracts and one-time requests	—	1,454	—	1,400
Subtotals	(68.0)	($8,025)	(68.0)	($7,971)
Commission on Health and Safety and Workers' Compensation				
Education and training program for worker safety and health	2.0	$1,060	1.0	$857[d]
Oversight of loss control services provided by insurance companies	2.0	137	1.0	91
Consultation with DWC on specified projects	—	30	—	—
Subtotals	(4.0)	($1,227)	(2.0)	($948)
Totals	**72.0**	**$9,252**	**70.0**	**$8,919**

a Includes proportional allocation of funding for requested operating expenditures and equipment.

b LAO recommends approval on a two-year limited-term basis.

c Reimbursement from Fraud Assessment Commission.

d LAO recommends approval of $749,000 in contract funds on a one-time basis.

- Creation of a Court Administrator to ensure uniform proceedings in the DWC judicial system and supervise the judges.
- Eight additional "judge teams" to handle existing case workload.
- Additional legal staff for (1) various rulemaking proceedings to implement provisions of Chapter 6 and (2) anticipated litigation arising from development of the pharmaceutical and outpatient surgery fee schedules mandated by the new law.
- One-time expenditures for (1) an extensive study of medical treatment costs and outcomes and (2) development of education and training materials for doctors who treat injured workers.
- Programs to (1) pilot education and training for worker safety and health and (2) oversee "loss control" services (that is, identification of workplace hazards and steps to mitigate them) provided by insurance companies.
- Additional vocational rehabilitation staff for anticipated additional workload related to settlements.
- Additional disability evaluation staff for anticipated new workload from a provision that allows multiple medical assessments.
- Additional health plan certification staff for anticipated increased workload.
- Additional claims audit staff to meet the new requirement that all insurance companies be audited at least every five years.

New Activities Do Not Justify Entire Request

We recommend that the Legislature approve $510,000 and six positions for anticipated vocational rehabilitation workload on a two-year limited-term basis. For other activities required by Chapter 6, we further recommend (1) deletion of $333,000 and two positions for absorbable or uncertain workload and (2) approval of $749,000 in contract funds on a one-time basis. (Reduce Item 7350-001-3030 by $249,000 and Item 7350-001-0223 by $84,000.)

As noted above, the request generally appears reasonable and consistent with the requirements of Chapter 6. However, the extent to which some anticipated workload will materialize and/or be ongoing in nature is uncertain, as we note below.

Ongoing Nature of Vocational Rehabilitation Workload Uncertain. The budget requests approximately $510,000 and six vocational rehabili-

tation positions for additional anticipated workload. Specifically, due to relaxed requirements for settling vocational rehabilitation claims with a lump-sum payment, the department expects an increase in (1) settlements of inactive cases and (2) challenges to eligibility for vocational rehabilitation services. In our estimation, settlement of inactive cases should constitute one-time workload, and it is unclear how many eligibility challenges will occur. Furthermore, the easier ability to settle vocational rehabilitation claims could, in fact, reduce ongoing workload in this unit by removing cases from the system more quickly. Consequently, we recommend approval of the request on a two-year limited-term basis.

Cost of Revising Claim Form and Notices Should Be Absorbed. The budget includes a one-time $54,000 request for consultants to revise (1) the benefits eligibility notice and claims form and (2) notices posted in the workplace and given to new employees, as required by Chapter 6. Specifically, these notices and forms must include particular information regarding workers' compensation in an easily understandable format available in English and Spanish. This authority to determine the content of notices and claims forms is part of the department's ongoing regulation of the workers' compensation system. Furthermore, it is relatively minor workload. As a result, we recommend that this one-time request be absorbed and, therefore, deleted from the proposal.

Worker Safety and Health Program. The budget proposes $1.1 million and two positions for CHSWC to develop and implement an education and training program for worker safety and health. This includes $186,000 for two administrative positions and $874,000 in consultant contracts for program development. The request proposes a pilot phase for the first year of the program. The proposal for consultant funds includes:

- Program design.
- Evaluation of the pilot program.
- Research to (1) identify high-risk industries for program targeting and (2) estimate business costs of injuries and potential savings from training.

We have two concerns with this portion of the request. First, one of the proposed positions (at a cost of $78,000) would spend more than half of his/her time on an annual report, even though the contract would include an evaluation. Second, research funding is proposed to determine future industry targeting ($125,000), although existing data that identify high-risk industries are available from the department's Division of Occupational Safety and Health and the U.S. Department of Labor. Consequently, we recommend deletion of $203,000 and one position for these purposes. Further, because the request is for a pilot phase in

2003-04, we recommend that the Legislature approve the remaining $749,000 request for contract funds on a one-time basis so that the need for continued funding can be reviewed next year.

Oversight of Loss Control Services. The budget also includes $137,000 and two positions for CHSWC to administer a loss control oversight program. Chapter 6 eliminated previous requirements that DIR (1) certify loss control consultation services provided by insurance companies to their clients and (2) audit insurers for compliance. Instead, Chapter 6 requires the department to (1) inform employers that insurers provide loss control consultation services and (2) respond to questions and complaints about services provided. The department has provided minimal justification for the two proposed positions. Its request relies on the expectation of a sizeable number of complaints and questions. It is unclear whether this workload will materialize. At this time, we recommend approval of one of the two positions, for a savings of $46,000. The need for additional resources could be reassessed once actual workload is known.

CHSWC Consultation to DWC. The budget proposes $30,000 for CHSWC to assist DWC in meeting particular requirements. Specifically, DWC must determine the form and content of workers' compensation information given to new employees as well as the benefits eligibility notice and claim form (discussed above). Chapter 6 also requires DWC to prepare a July 1, 2004 report on injured workers' access to disability funds (especially migratory and seasonal farm workers). The DWC is to consult with CHSWC in performing these functions, but DWC has primary responsibility for fulfilling these requirements. Since DWC is responsible for these items, we recommend deletion of the proposed $30,000 funding for CHSWC.

Summary of Recommended Approach. Figure 1 shows the net effect of our recommendations compared with the budget proposal. Specifically, we recommend:

- Deletion of $333,000 and two positions for CHSWC activities and revision of notices and forms by DWC.
- Approval of $749,000 in contract funds for worker safety and health on a one-time basis.
- Approval of $510,000 and six positions for vocational rehabilitation on a two-year limited-term basis.

Option to Defer Some Requests

If the Legislature would like to further limit the cost of this proposal in response to the state's fiscal condition, there are $3 million in additional savings (beyond the above recommendations) that could be achieved by deferring some requests to see if anticipated workload materializes and by relying on existing fraud and workplace safety programs.

As discussed previously, the overall request appears reasonable and consistent with the requirements of Chapter 6. If the Legislature, however, would like to limit the cost of this proposal in response to the state's fiscal condition, some items could be deferred to see if anticipated workload materializes. These items include the proposals for vocational rehabilitation, disability evaluations, and certification of health plans to provide workers' compensation-related treatment. This would save $1.1 million and 14 positions.

By deferring implementation of fraud initiatives and the education and training program, an additional $1.9 million in savings (and one position) is possible. The department has existing business inspection programs that cover labor law enforcement and workplace safety. Our review of these inspection programs in the *2002-03 Analysis* showed that over the last several years, workplace injuries have declined and the department has found fewer labor law and safety violations. Given this improved compliance record for the existing inspection programs, we think the specific fraud and worker-focused safety and health activities mandated by Chapter 6 could reasonably be deferred.

As described above, the Governor proposes to shift the costs of workers' compensation programs from the General Fund to the employer assessment. If this proposal is approved, the additional savings described above would accrue to employer, insurance company, and health plan fee/assessment funds. These assessments could be reduced accordingly. If, however, the fund shift proposal is rejected, these savings would accrue both to the General Fund and the fee/assessment funds—$2.2 million and $0.8 million, respectively.

DEPARTMENT OF PERSONNEL ADMINISTRATION (8380)

The Department of Personnel Administration (DPA) manages the nonmerit aspects of the state's personnel system. (The State Personnel Board manages the merit aspects.) The Ralph C. Dills Act provides for collective bargaining for most state employees and sets the parameters for nonmerit aspects of state employment. Under this act, DPA is responsible for (1) reviewing existing terms and conditions of employment subject to negotiation, (2) developing management's negotiating positions, (3) representing management in collective bargaining negotiations, and (4) administering negotiated memoranda of understanding (MOUs). The DPA also is responsible for the compensation and terms and conditions of employment of managers and other state employees not represented in the collective bargaining process.

In addition to these personnel-related activities, DPA administers (1) the Rural Health Care Equity program, which subsidizes specified health insurance costs for state employees and retirees living in areas without health maintenance organization (HMO) options and (2) the Savings Plus deferred compensation program.

The budget proposes total expenditures of $65 million for support of the department in 2003-04. The principal funding sources are:

- $38 million from the General Fund.
- $17 million from reimbursements from other state departments.
- $8 million from the Deferred Compensation Plan Fund.

Need for Staff to Process Layoffs Unclear at This Time

We withhold recommendation on the $1.8 million General Fund proposal for 29 one-year limited-term positions to process 10,000 layoffs, pending legislative decisions on programmatic and compensation reductions that will solidify the likely number of layoffs.

The budget proposes $1.8 million General Fund and 29 one-year limited-term positions to support DPA activities driven by an anticipated 10,000 layoffs. (This proposal represents the continuation of a $1.7 million General Fund deficiency request for the current year.) This request includes the following components:

- ***Classification and Compensation Division.*** Funding of $291,000 for overtime and other expenses to (1) administer the layoff process, (2) perform the individual seniority calculations that determine who receives layoff notices, and (3) approve demotional patterns that allow noticed employees to bump down to lower classifications (thereby deflecting layoffs to employees in lower ranking classifications).
- ***Labor Relations Division.*** Funding of $383,000 and ten positions to (1) conduct layoff impact negotiations with employee unions, as required in MOUs, and (2) conduct grievance hearings filed by employees subject to layoff.
- ***Legal Division.*** Funding of $1.1 million and 19 positions to (1) hear layoff appeals and (2) litigate arbitration proceedings of employees who appeal the outcome of DPA grievance hearings.

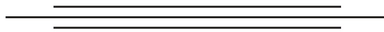
Number of Likely Layoffs Unclear at This Time. The Governor's budget eliminates approximately 2,000 positions due to proposed program reductions. It is our understanding that an estimated 1,500 of these positions are filled. In addition, the budget proposes an $855 million reduction in employee compensation costs. This reduction could be achieved through a number of measures—salary cuts, reduced benefits, furloughs, and layoffs.

Given these proposals, we think some amount of layoffs is possible. This is because the state's flexibility to absorb position reductions by moving employees to other vacant positions has been significantly reduced through elimination of more than 12,000 vacancies since 2000-01. In addition, the state has cut and eliminated programs, along with their associated positions, to reduce state expenditures.

It is unclear at this time, however, as to the number of layoffs that might occur. For example, the Legislature may wish to accept the proposed programmatic reductions while approving a lower level of em-

ployee compensation cuts. Alternatively, the administration's negotiations with employee unions might result in compensation reductions that occur mainly through salary and benefit cuts or furloughs, as opposed to layoffs. Either scenario would result in far fewer than 10,000 layoffs.

As a result, with the number of layoffs uncertain, we withhold recommendation on this proposal pending legislative decisions on programmatic and compensation reductions.



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 $269 million and 1,811 positions in 2003-04 for the department, including $93 million from the Agriculture Fund and $87 million from the General Fund. The proposed expenditures are $32 million, or 11 percent, below estimated current-year expenditures due to a variety of proposed program reductions.

ANIMAL CONTROL STATE 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. We recommend the Legislature suspend the mandate to reimburse local governments for the increased costs resulting from animal control. Furthermore, we recommend the Legislature refer the matter to the Joint Legislative Audit Committee for review of (1) the existing claims (about $79 million) to ensure that they are appropriate and (2) the parameters and guidelines to ensure that they specify the offsetting savings and revenues to be deducted from claimed costs.

Background

Local Governments 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 Enacted to Prevent the Euthanization of Adoptable Stray Animals. Seeking to prevent 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 a Reimbursable Mandate. In 2001, responding to a claim by local governments, the Commission on State Mandates found Chapter 752 to impose a reimbursable mandate. The commission found, in part, that Chapter 752 increased costs by requiring the housing and caring for these animals longer than the three days previously required by law and other specified activities. To guide local agencies in their preparation of mandate claims, the commission adopted a reimbursement methodology referred to as the mandate's parameters and guidelines, or "Ps&Gs." Local agencies, in turn, submit claims to the State Controller's Office (SCO).

Usually for a new mandate, the administration proposes funds in the May Revision to reimburse local governments, and the Legislature appropriates the funds in the annual claims bill. After the mandate is funded in the claims bill, the mandate is included in the budget bill for future funding. The costs of this mandate have not yet been included in a claims bill and, therefore, also do not appear in the *2003-04 Budget Bill.*

Mandate Costs Much Higher Than Anticipated

To date, local entities have submitted a total of $52 million in claims for the past four fiscal years. Based on the claims submitted thus far, the commission projects that the mandate will cost $79 million through 2003-04 with an ongoing annual cost of roughly $14 million. Since the local entities are still authorized to submit claims for the past two fiscal years, the cost of these claims is likely to increase.

Offsetting Revenue and Savings Expected. The mandate's cost is noteworthy given that, at the time the Legislature enacted the animal control mandate, there was some question as to whether the legislation would even qualify as a state-reimbursable mandate. This is because it was expected that much of the increased costs would be offset by revenues and savings from animals kept longer than three days and subsequently adopted. Under prior law, these animals would have been euthanized after three days. By holding them longer than three days, local governments experience increased costs from the additional holding time. At the same time, local governments experience reduced costs due to fewer animals euthanized and receive increased revenues from adoption and redemption fees.

Claimed Costs Likely Overstated. These reduced costs and increased revenues would, at least partially, offset the increased holding time costs. While the Ps&Gs generally require the local governments to claim any offsetting savings or reimbursements resulting from this mandate, the direction is not sufficiently explicit. In our view under Chapter 752, every local government should experience an increase in revenues because of the increase in fees collected for animal placement and increased savings because of the decrease of animals euthanized. We would expect every claim, therefore, to include a deduction of some level of savings and reimbursements to offset claimed costs. In the course of our analysis, however, we reviewed a sample of animal control claims submitted to the SCO and found that most local entities claimed costs without deducting any offsetting revenues or savings. We believe, therefore, the claimed costs are likely overstated. While the net fiscal effect of the mandate may result in some cost to the local governments, the associated savings currently not accounted for is likely significant.

Wide Variation in Local Government Claims. Furthermore, there is great variation in the types of costs claimed by local governments. Salinas, for example, claimed over $1 million to acquire additional space in 1999-00, and the City of Los Angeles claimed over $400,000 over a three-year period for computer software. Some other entities have claimed no costs for either of these items since the date the mandate became effective.

What Explains the Higher-Than-Anticipated Costs and Variation? We suspect that the higher-than-anticipated costs are a result of local governments not appropriately deducting offsetting savings or revenues from claimed costs. More explicit Ps&Gs that define the offsetting savings and revenues to be deducted from the claims would likely minimize this situation. We also suspect that some of the variation is likely attributable to the significant difficulty state and local agencies face in defining and estimating state-reimbursable costs when only part of a program is state-reimbursable. Specifically, since only incremental shelter costs are eligible for reimbursement, drafting Ps&Gs and filing claims that accurately differentiate "base" program expenditures from "mandated" program expenditures is difficult.

LAO Recommendation: Prior-Year Costs Need Review

Given the costs of the claims and the significant variation in amounts, it is possible that some local governments are claiming costs not permissible under the Ps&Gs. To the extent that the local governments are claiming inappropriate costs, SCO's audits should remedy this problem. If much of the problem, however, pertains to ambiguities in the Ps&Gs related to offsetting savings and revenues, as we suspect, no existing state administrative process will automatically remedy this problem. Instead, state costs associated with ambiguities in Ps&Gs tend to escalate as local governments learn how to maximize state reimbursements.

In 2000, the Legislature faced an analogous problem when considering the "School Bus Safety II" mandate. Specifically, some school districts submitted claims for as much as $10,000 per school bus to implement relatively modest procedural safety safeguards. To examine this matter more fully, the Legislature requested the Joint Legislative Audit Committee (JLAC) to review the mandate's Statement of Decision, Ps&Gs, and district claims. Given the cost of the claims involved in the animal control mandate, we recommend the Legislature again ask JLAC to conduct an audit to:

- Identify whether local governments have prepared claims in a manner consistent with the Ps&Gs.
- More clearly define what qualifies as offsetting savings and reimbursements to be deducted from claimed costs.
- Identify the elements of the mandate that represent the greatest cost.

Pending receipt of this audit, we recommend the Legislature not fund this claim in the claims bill anticipated in May of this year. While the state would incur an interest penalty at the Pooled Money Investment

Account rate (currently less than 3 percent) on unpaid meritorious claims, the interest cost is modest compared to the dollars at stake.

LAO Recommendation: Suspend Animal Control Mandate in Budget Year

Given the concerns outlined above, we believe it would be imprudent to incur additional mandate liabilities until the results of the JLAC audit are known. Consequently, we recommend suspending the mandate in the budget year. To achieve this, the Legislature would need to show a $0 appropriation for this mandate in the budget bill (Item 8570-295-0001) with the following language:

> Pursuant to Section 17851 of the Government Code, mandates identified in the appropriation schedule of this item with an appropriation of $0 and included in the language of this provision are specifically identified by the Legislature for suspension during the 2003-04 fiscal year:
>
> (1) Animal Control (Ch 752, Stats of 1998)

INDUSTRY SHOULD CONTRIBUTE TO MEDFLY CONTROL

We recommend the enactment of legislation authorizing the department to assess fees for the nonfederal cost of the Medfly Preventative Release Program. (Reduce Item 8570-001-0001 by $8.9 million.)

Proposal to Make Medfly Control Program Permanent. The Governor's budget proposes to fund Mediterranean Fruit Fly (medfly) control on an ongoing basis and provides $8.9 million for this purpose. The department began efforts to control the impact of the medfly on California's agricultural industry in 1975. Since 1980, the state has spent around $150 million from the General Fund to support this effort, with a similar amount provided by the federal government. The department has used aerial and ground spraying, and sterile medfly releases to fight the pest.

The current Preventative Release Program (PRP) began in 1996 and involves raising sterile medflies and releasing them throughout a 2,100 square mile area of the Los Angeles Basin. Total program costs are $18 million annually, shared equally between the state and the federal government. The Legislature approved the program for five years with a June 30, 2001 sunset date. The *2001-02* and *2002-03 Budget Acts* each extended the program for one additional year.

Department Continues to Ignore Legislative Direction to Examine Different Funding Mechanisms. During the 2002-03 budget hearings, the Legislature expressed concern over the General Fund obligation for this program. The Legislature approved General Fund spending for one additional year. The Legislature also directed the department, through budget bill language, to provide information by January 10, 2003 detailing how funding for the PRP could be shifted in whole, or in part, to the Agriculture Fund. At the time this analysis was prepared, the department had not submitted the report to the Legislature. We note that during the 2001-02 budget hearings the Legislature had directed the department to provide the same information by January 10, 2002, and it was never submitted to the Legislature.

Industries That Benefit Should Share in the Cost. 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 fruit growing industries including peaches, pears, lemons, limes, and oranges. 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.

Recommend Industry Funding for Program Costs. Accordingly, we recommend enactment of legislation to direct CDFA to develop an assessment program that would equitably distribute the nonfederal cost of the PRP across those industries that most benefit from the absence of the medfly. This assessment should be distributed in such a manner as to maximize participation—thereby minimizing the economic impact on any individual industry.

CALIFORNIA CONSUMER POWER AND CONSERVATION FINANCING AUTHORITY (8665)

The California Consumer Power and Conservation Financing Authority (California Power Authority, or CPA) was created by Chapter 10x, Statutes of 2001 (SB 6x, Burton), to assure a reliable supply of power to Californians at just and reasonable rates, including planning for a prudent energy reserve. The CPA was also created to encourage energy efficiency, conservation, and the use of renewable resources.

In order to meet these goals, CPA is authorized to purchase, lease, or build new power plants to supplement private and public sector power supplies. It may also finance energy conservation programs and renewable energy projects. The financing for these projects is provided by $5 billion in revenue bonding authority, with any bonds issued being secured by the revenues generated from the specific projects being financed by CPA. In addition, CPA has also been given the authority to finance natural gas transportation and storage projects that have been recommended by the California Public Utilities Commission, as well as provide financing to retrofit old and inefficient power plants.

Proposed Budget. The budget proposes $228.4 million for CPA in 2003-04, of which $4.3 million is for administrative support and the balance for various energy-related projects, including reliability power projects. Only CPA's administrative support budget is subject to an appropriation in the budget bill. Funding for all of CPA's expenditures is from the California Consumer Power and Conservation Financing Authority Fund. The budget proposes that this special fund receive most of its revenues in the budget year from the sale of revenue bonds, the sale of power from the authority's projects, and from loans from other special funds.

Authority Has Not Achieved Financial Self-Sufficiency

The California Power Authority (CPA) has had difficulty implementing its mission since its inception and has not achieved financial self-sufficiency, resulting in the need for additional loans to support its ongoing operations. We also have concerns with CPA's ability to become financially self-sufficient in the future. Therefore, we withhold recommendation on CPA's support budget until the Legislature receives and reviews two reports on CPA's plan to implement its mission and become financially self-sufficient.

History of CPA's Funding. The statute that created CPA stated the Legislature's intent that CPA would be supported by revenues from investments it made with its bonding authority. Recognizing that CPA would need start-up capital to get its operations going, the *2001-02 Budget Act* included a $10 million General Fund loan to CPA that could be spent after approval of the Department of Finance and review by the Joint Legislative Budget Committee. Of this original loan amount, CPA has been allocated approximately $8.9 million over the last two years. In the current year, the entire loan balance of $8.9 million was switched from the General Fund to the Renewable Resources Trust Fund of the Energy Resources Conservation and Development Commission (California Energy Commission, or CEC). (This switch had the effect of freeing up the General Fund amount.)

To date, CPA has not invested in any projects that would generate revenues significant to both repay its start-up loan and pay for its ongoing support costs. Given this, the budget proposes an additional $1.9 million loan from the CEC's Energy Resources Program Account for CPA's support activities in 2003-04. The budget projects that $6.5 million will remain owing to CEC at the end of the budget year, after partial repayments are made.

Authority's Projects Have Not Generated Significant Revenues. In a report to the Legislature dated December 15, 2002, CPA reported that it had generated $2.3 million in revenues since its inception. The majority of its revenues (over 75 percent) were the result of settlements from the state's efforts at renegotiating contracts with electricity providers, not from projects pursued directly by the authority. (For a discussion of these settlement funds, please see our write-up in the "Crosscutting" section of the Resources Chapter.) The CPA also reported that it is working on several different projects that it expects will generate revenues in the current and budget years. However, it is not clear at this time whether any of these projects would provide sufficient ongoing revenues to support CPA activities in the future. Given this, we have concerns regarding CPA's abil-

ity to generate revenues to support its ongoing operations and repay its loan from CEC.

Withhold Recommendation Pending Receipt of Reports Addressing Self-Sufficiency. The *Supplemental Report of the 2002 Budget Act* required CPA to submit a report on its long-term budgetary needs by December 31, 2002. At the time this analysis was prepared, the report had not been submitted to the Legislature. In addition, the authority's statutorily required annual Energy Resources Investment Plan is due to the Legislature in mid-February. This report is required to outline a strategy for cost-effective energy resource investments by CPA that will address state issues relating to adequacy of energy supply, reliability of service, and environmental quality. These two reports should provide the Legislature with information regarding how CPA plans to become self-sufficient and repay its loan obligations. Therefore, we think that the Legislature should evaluate these reports before making any decisions regarding CPA's budget. Given this, we withhold recommendation on CPA's support budget ($4.3 million from the California Consumer Power and Conservation Financing Authority Fund) pending the receipt and evaluation of the reports mentioned above.

Department of Veterans Affairs and Veterans' Homes of California (8955-8966)

The Department of Veterans Affairs (DVA) provides services to California veterans and their dependents, and to eligible members of the California National Guard. The principal activities of the DVA include: (1) providing home and farm loans to qualifying veterans using the proceeds from the sale of general obligation and revenue bonds; (2) assisting eligible veterans and their dependents to obtain federal and state benefits by providing claims representation, subventions to county veterans service offices, and direct educational assistance to qualifying dependents; and (3) operating veterans' homes in Yountville, Barstow, and Chula Vista with several levels of medical care, rehabilitation services, and residential services.

The budget proposes total expenditures of $328 million in 2003-04. This is $8.1 million less than estimated current-year expenditures. Expenditures of $62 million from the General Fund are proposed for the budget year, which is $1.9 million, or 3 percent, less than the estimated current-year level. The budget year decrease in General Fund mainly consists of positions eliminated under Control Section 31.60, and reductions to operating expenses and out-of-state travel. General Fund support for local assistance for the County Veterans Service Offices would be reduced by $470,000, a 21 percent reduction from the current year. Finally, the Governor proposes a 7.5 percent fee increase for residents of the domiciliary wings of the state's veterans homes.

Fee Increases for Home Residents Should Be Broadened

The Governor proposes a 7.5 percent fee increase for residents of the domiciliary wings of the state's veterans' homes. In light of the significant increases that have occurred in the cost of operations at the home, and also to ensure equity in the payments by all home residents, we

recommend extending the same increase to individuals in skilled nursing facilities at the same veterans' homes and related changes to help offset state costs for operating the facilities. Accordingly, we recommend that the Legislature reduce the General Fund appropriations for the home by the collective amount of $475,000. (Reduce Item 8960-011-0001 by $290,000, Item 8965-001-0001 by $91,000, and Item 8966-001-0001 by $94,000.)

Background. The state operates three veterans' homes located in Yountville, Barstow, and Chula Vista, with the collective capacity to house almost 1,900 veterans. All three homes provide a range of living accommodations designed to meet the needs of aging and disabled veterans. This includes domiciliary living quarters both for veterans who live independently as well as those who require some assistance with day-to-day living. Intermediate care facility (ICF) beds are available for veterans with ongoing, daily medical needs, and skilled nursing facilities (SNFs) are provided for those veterans requiring intensive medical care. Yountville also includes an acute care hospital.

The domiciliary beds, ICFs, and SNFs are operated as separate units located within different sections of each of the veterans' homes. The department projects a total 2003-04 home population of approximately 1,700 veterans, with 1,081 or 63 percent in domiciliary care, 197 or 12 percent in ICFs, and 419 or 25 percent in SNFs.

All veterans home residents are assessed member fees based upon the level of care they receive and their income. Residents living in domiciliary settings pay 47.5 percent of their income in member fees up to a $1,200 monthly cap. Residents living in ICFs pay 65 percent of their income in member fees up to a $2,300 monthly cap, and residents living in SNFs pay 70 percent of their income in member fees up to a $2,500 monthly cap. In exchange, veterans receive room, board, medical care, and the opportunity to participate in a variety of programs and activities provided by the homes. Member fees cover approximately 14 percent of the cost of operating and maintaining the veterans' homes, with General Fund support (52 percent of total funding) and reimbursements and federal trust funds (34 percent) making up the remainder. California's three veterans' homes are among the 137 nursing homes and 43 domiciliaries operated nationwide in cooperation with the U.S. Veterans Administration.

Prior Fee Reduction Would Be Reversed. Chapter 118, Statutes of 2001 (SB 742, Escutia), reduced member fees for domiciliary beds in the veterans' home by 7.5 percent, specifically by lowering them from 55 percent of each member's monthly income to 47.5 percent. The measure did not change the ceiling on fees of $1,200 per month.

The Governor's budget proposes a statutory change to reverse this fee reduction, by restoring domiciliary members' fees to 55 percent of

monthly income. The budget assumes this change generates an additional $1.2 million in fee revenues that would be used to offset General Fund expenditures in 2003-04. Under the Governor's proposal, the maximum monthly payment ceiling would remain unchanged at $1,200.

Other States Already Charge More for Care. The available data indicate that veterans' homes in some other states are charging their residents higher fees than does California's homes. Figure 1 shows the results of a survey of such charges imposed in other states that was conducted by the California Research Bureau in November 2001. As the figure shows, California veterans living in domiciliary settings pay a maximum of $39 per day. Veterans in Michigan and Kansas pay a similar amount while veterans in Illinois pay less. However, Pennsylvania, Wisconsin, Oklahoma, and Florida all have a higher maximum daily member fee than California. On average, veterans living in domiciliary care in these states pay a maximum of $54 dollars per day.

Figure 1

How California Veterans' Homes Fees Compare With Other States

Veterans' Home Maximum Fees
Domiciliary Care

	Cost Per Day
Illinois	$24
California	**39**
Kansas	41
Michigan	43
Florida	52
Oklahoma	62
Wisconsin	75
Pennsylvania	98
Average	**$54**

Disparity in Share of Fee Support. Under the Governor's proposal, residents of ICF and SNF nursing beds in the veterans' homes would continue to pay a relatively smaller share of the cost of their care compared to members of domiciliary beds, even though ICF and SNF beds are far more costly to operate.

The average annual cost per bed for domiciliaries (averaged across all three veterans homes) is projected to be $38,550 in 2003-04. Including the fee increase proposed by the Governor, members in domiciliary beds would pay up to $14,400, or 37 percent of their per-bed cost over the course of a year.

The projected average annual cost per bed is $96,500 for ICFs and $135,100 for SNFs. Under the fee structure now in place, and proposed for continuation in 2003-04, a veteran making the maximum allowable annual contribution for ICF care would pay $27,600 or 29 percent of the cost of their care, while SNF residents would pay $30,000 or 22 percent of the cost of their care.

As a result of this fee structure, veterans in ICFs and SNFs account for $62 million or 56 percent of the total veterans' homes budget while accounting for 36 percent of the total home population. Given the level of services they receive, the Legislature may wish to consider whether ICF and SNF residents should also share in any member fee increase.

Monthly Payment Limits Need Adjustment. The monthly payment limits of $1,200 for domiciliary, $2,300 for ICFs, and $2,500 for SNFs were established in 1994 and have never since been adjusted for the effects of inflation. Figure 2 (see next page) shows that, since 1994, the average cost per bed has increased substantially at Yountville, which houses 64 percent of the total veterans' home population. The chart excludes Barstow, which came on line in 1996, and Chula Vista, which opened in 2000 because one-time startup costs skew the cost per bed averages upward. An adjustment to upper payment limits to bring each of them in line with inflationary cost increases would generate up to $225,000 in additional revenues annually that could be used to help offset the cost to the state of operating the homes.

Analyst's Recommendation. Given the significant increases that have occurred in the cost of operating the veterans' homes, we believe it is reasonable for the veterans to assume a slightly greater share of the costs for the services they receive at the state veterans homes. Accordingly, we recommend the Legislature approve the Governor's proposed fee increase of 7.5 percent for veterans in domiciliary accommodations, in effect restoring the level of fees they had been paying under a recent change in state law.

In order to make cost-sharing more equitable in its effect among all home residents, we further recommend that the fee increase be extended to include veterans in ICFs and SNFs. Under our proposal, member fees for ICFs (now set at 65 percent of their income) and SNFs (70 percent of their income) would increase to 72.5 percent and 77.5 percent, respectively. We estimate that our modification of the Governor's fee proposal would

result in additional annual revenues of $250,000. The 7.5 percent fee increases proposed are significantly less than the increases which have occurred in the cost of care. We also recommend increasing the monthly payment limits now imposed on fee collections for the effects of 24 percent inflation since 1994, a change which could generate up to another $225,000 in annual revenue.

Figure 2

While Veterans' Home Operating Costs Have Grown, Fee Limits Have Not

	Cost Per Bed (Yountville)			
	1994-95	2003-04	Difference	Percent Increase
Skilled nursing facility	$88,049	$116,910	$28,861	33%
Intermediate care facility	54,985	80,824	25,839	47
Residential care	24,886	44,620	19,734	79
Domiciliary	15,532	36,563	21,031	135
Maximum Monthly Fee				
Skilled nursing facility	$2,500	$2,500	—	—
Intermediate care facility	2,300	2,300	—	—
Residential care	1,200	1,200	—	—
Domiciliary	1,200	1,200	—	—

The additional revenues generated through these modifications of the Governor's fee proposal could be used to help offset the cost to the state of operating these facilities. Accordingly, we recommend the Legislature reduce the General Fund for the homes by the collective amount of $475,000.

Relatively Few Home Residents in Medi-Cal

We recommend that the Legislature direct the Department of Veterans Affairs (DVA) to report during budget hearings on the feasibility of providing financial planning services to residents entering the veterans' homes that may help them become eligible for Medi-Cal benefits. We also recommend the DVA report on the costs and benefits of such an approach. Such a change would apply only to veterans entering the veterans' homes, not to veterans already living in them, and could eventually generate millions of additional federal dollars that could help offset the growing state costs for the support of these facilities.

Background

Currently, medical services provided at the state's veterans' homes are eligible for funding through the Veterans Administration and Medicare programs. However, these programs cannot be used to help offset the costs of long-term care provided in the nursing facilities at the homes. Instead, a portion of nursing facility costs is covered for eligible veterans under the Medi-Cal Program. In order for a resident at a veteran's home to be eligible for long-term care under the Medi-Cal Program, he/she must meet various requirements, including income levels and limits on personal assets. Some assets are exempt from the asset limits and generally not counted when determining eligibility. For example, homes, automobiles, business-related property, certain life insurance policies, pension funds, and cash up to certain amounts can all be exempted from the limit under certain defined circumstances.

More Veterans Could Be Eligible for Medi-Cal. Approximately 30 percent of the residents of the nursing facilities in the state's veterans' homes have been determined to be Medi-Cal eligible, according to DVA. Individuals applying for admission to the state's veterans' homes are currently required to disclose their personal finances for purposes of determining their Medi-Cal eligibility. Our analysis indicates that this portion of the population enrolled in Medi-Cal is relatively low compared to other nursing homes operating in California. This has important ramifications for the revenues used to support the veterans' homes.

Statewide, approximately 65 percent of revenue for nursing facilities comes from Medi-Cal, while only about 11 percent of veterans' home nursing facility reimbursements are from Medi-Cal. If additional veterans' home residents were eligible for Medi-Cal, a greater share of the operating costs of the homes could be supported with federal funds and less state funds would be needed for this purpose.

Approaches to Increasing Medi-Cal Eligible Residents. On the basis of income, many of the existing residents of the homes are eligible for Medi-Cal. However, some residents are not eligible for Medi-Cal because their assets exceed certain limits. Under federal law, certain types of actions are permissible to restructure an individual's assets in order to achieve Medi-Cal eligibility. One approach the state could take would be to assess veterans' assets to determine whether they could be eligible for Medi-Cal. Under such an approach, the state would receive additional funding for patient care and a veteran could maintain control of his assets, and would have access to them in the event he later decided to move out of the veterans' home. Currently, no such planning services are provided to veterans through the veterans' homes that could assist in making such arrangements.

Analyst's Recommendation. Given the significant increases in costs that have occurred in the veterans' home operations, we recommend that the Legislature examine ways to increase the number of home residents enrolled in the Medi-Cal Program.

Specifically, we recommend that the Legislature direct DVA to report during budget hearings on the feasibility of providing financial planning services to veterans entering the homes in the future to ascertain whether their assets could be restructured to meet Medi-Cal requirements. The department should also report on the costs and benefits of such an approach.

If the state could double the amount of Medi-Cal reimbursements it now projects it will receive, it would realize approximately $3 million in additional federal funds that could be used to offset General Fund support for these facilities. Given the large share of support other nursing homes currently receive from Medi-Cal, we believe the benefits to the state could eventually be even larger.

We caution that these fiscal benefits would grow over time, but would probably not be substantial during 2003-04. This is because this approach would target new residents admitted to the home, not the large number of existing residents. However, the cumulative effect of such a change could become significant over time as more and more home residents were enrolled in Medi-Cal.

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 2003-04 relief of $1.6 billion, of which $627 million is appropriated in the budget bill. The remainder is spending on the Vehicle License Fee (VLF) "backfill," which is distributed to localities and budgeted through a continuous appropriation. The budget proposes major reductions in VLF backfill spending in both the current year and budget year as detailed below.

After the VLF backfill, the second largest tax relief program is the homeowners' exemption ($420 million), which provides tax relief to approximately 5 million homeowners. This program, which is required by the State Constitution, grants a $7,000 property tax exemption on the assessed value of owner-occupied dwellings, and requires the state to reimburse local governments for the resulting reduction in property tax revenues. The exemption reduces the typical homeowner's taxes by about $75 annually. In order to accommodate the expected growth in the number of homeowners claiming the exemption, the Governor's budget proposes an increase of $5.4 million, or 1.3 percent, over the amount budgeted for 2002-03.

VLF Backfill Reduction Proposed

The VLF is an annual fee on the ownership of a registered vehicle in California, levied in lieu of taxing vehicles as personal property. The revenues are distributed to cities and counties.

Reductions in the VLF Rate. Since 1998, the Legislature has reduced the VLF by 67.5 percent—from the historic 2 percent rate down to 0.65 percent. This rate is assessed on the depreciated value of the vehicle. For all VLF reductions, cities and counties continue to receive the same amount

of revenues as under prior law, with the reduced VLF amounts replaced by General Fund spending. Thus, the state makes up the difference between what would be raised with a 2 percent VLF rate and the amount actually raised with the effective 0.65 percent rate. This spending for local government subventions is known as the "VLF backfill."

The backfill is comprised of two components: (1) the *base* VLF backfill, which constitutes about three-fourths of the total; and (2) the *realignment* VLF backfill, representing the remaining one-quarter. The base VLF backfill may be used by local governments for any spending purpose, while the realignment VLF backfill must be used only for programs associated with the 1991 realignment of various health and social services programs.

Governor Proposes to Eliminate Base Backfill. Under current law, the amount of the VLF backfill that is scheduled to be provided to local governments is approximately $3.8 billion in 2002-03. Roughly $2.9 billion of this is base backfill and the remaining $900 million is realignment backfill. The Governor's proposal is to eliminate the backfill associated with the base VLF in both the current year (beginning February 1, 2002) and the budget year. The realignment portion of the backfill would continue under the Governor's proposal.

The proposed budget would allow for substantial General Fund savings through reductions in state subventions to local governments in both the current and budget years. Based on the Governor's elimination of the base backfill beginning in February, the savings would amount to approximately $1.3 billion in the current year, with budget-year savings of approximately $2.9 billion. The elimination of the base VLF backfill would not result in an increase in the VLF paid by vehicle owners, but simply eliminate the amount paid by the state to localities.

Revenues From the VLF Are Important for Local Governments. The VLF revenues distributed to cities and counties typically represent one of their three largest sources of general-purpose revenues. Cities and counties use general-purpose revenues to pay for a wide variety of services, including police, fire, and health care.

Should Localities Bear the Burden? In response to the Governor's proposed reduction in the VLF backfill, there has been extensive legislative debate regarding measures that would increase the effective VLF rate paid by vehicle owners. Given the fluidity of these proposals and accompanying discussion, it is difficult to develop a specific recommendation regarding the VLF backfill for this publication. In general, however, we believe that is it inappropriate for cities and counties to bear major fiscal losses due to a state decision to offer tax relief. In addition, deleting funding for the backfill without a commensurate increase in the

VLF rate would cause significant disruption in local government budgets and increase intergovernmental tension.

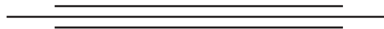
Elimination of Subventions for Open Space

We recommend that the Legislature provide for the phaseout of the Williamson Act contracts instead of ending this program immediately, as proposed by the budget.

The Williamson Act allows cities and counties to enter into contracts with landowners to restrict their property to open space and agricultural use. In return for the restriction, the property owner pays reduced property taxes because the land is assessed at lower than the maximum level. The amount of the state subvention to localities is based on the amount and type of land under contract, rather than the actual reduction in local property tax revenues.

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

In 2002-03, $39 million was budgeted to subvene to local governments that had entered into *Williamson Act* contracts. The 2003-04 budget proposes to eliminate the entire funding for this item, thus ending state support for the program. Since the contracts are noncancelable under most circumstances, this elimination of the subvention would result in immediate uncompensated tax losses to local governments. We have previously questioned the effectiveness of the program, but believe there is a more reasonable means of achieving the Governor's intent to eliminate the program. Specifically, we recommend that the Legislature phase out the subventions generally coinciding with the gradual increase in property taxes received by participating local governments. An alternative to the Governor's budget would be to reduce the funding for the program by 10 percent annually. This approach would save $3.9 million in 2003-04, with the full $39 million in annual savings realized after the full ten-year phaseout of subventions.



HEALTH AND DENTAL BENEFITS FOR ANNUITANTS (9650)

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

Budget-Year Costs Not Yet Completely Determined

We withhold recommendation on the $660 million General Fund request for annuitant benefits pending final determination of health insurance premium rates for calendar year 2004.

The budget proposes total expenditures of $660 million from the General Fund for health and dental benefits for annuitants in 2003-04. This is $84 million, or 15 percent, more than estimated expenditures for this purpose in the current year. This increase mainly reflects 2003 health insurance premium increases that topped 25 percent. It does not include any changes in health insurance premiums that would go into effect January 1, 2004. Figure 1 displays General Fund expenditures for annuitant health and dental benefits for the three fiscal years starting with 2001-02. Although these costs are initially paid from the General Fund, the state recovers a portion of these costs (about 33 percent) from special funds through pro rata charges.

The actual amount needed in the budget year is dependent on negotiations over health insurance premiums currently underway between the Public Employees' Retirement System and providers. These negotiated premium rates, which will cover the 2004 calendar year, should be available for review during legislative budget hearings. Pending receipt

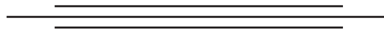
of the new rates, we withhold recommendation on the amount requested under this item.

Figure 1

Health and Dental Benefits For Annuitants

(In Millions)

Program	2001-02 Actual	2002-03 Estimated	2003-04 Budgeted
Health	$410.4	$526.8	$605.6
Dental	47.1	49.8	54.9
Totals	**$457.5**	**$576.6**	**$660.5**



AUGMENTATION FOR EMPLOYEE COMPENSATION (9800)

A significant portion of state government's operating costs is for compensation of state employees. Figure 1 displays a breakdown of 2002-03 estimated state payroll (without additional benefits expenditures for items such as health insurance and retirement). As shown in the figure, higher education (consisting of the University of California [UC] and California State University [CSU] systems) represents approximately one-third of state employment. The Departments of Corrections and Transportation combined represent an additional one-fifth of state payroll.

The Governor's budget projects $17 billion in salary and wage expenditures for 325,000 authorized personnel-years (PYs) in 2003-04 (including $6.1 billion and almost 118,000 PYs in higher education). In addition, the state pays for benefits such as health insurance and retirement. These additional employment costs are generally around 25 percent of salary expenditures. Thus, when benefits are included, total estimated expenditures for employee compensation are projected to approach $22 billion for the budget year, about half of which is supported from the General Fund.

Employee Pay and Benefit Increases

The budget does not include funding for the general salary increases—5 percent for most state employees—effective July 1, 2003, as negotiated in current memoranda of understanding. The budget, however, does include $12 million ($11 million General Fund) for some additional cost provisions negotiated in two contracts.

Most State Employees Scheduled for 5 Percent Salary Increase. Under current memoranda of understanding (MOUs) (contracts that govern terms and conditions of employment), the employee retirement con-

tribution was cut in half during 2001-02 and then eliminated for 2002-03—in order to increase take-home pay without incurring additional state costs for an increase in base salaries. (The Public Employees' Retirement System approved this reduction in pension system revenue, which will increase state retirement contributions beginning in 2003-04.) Employees will be required to make their full contributions again beginning in 2003-04.

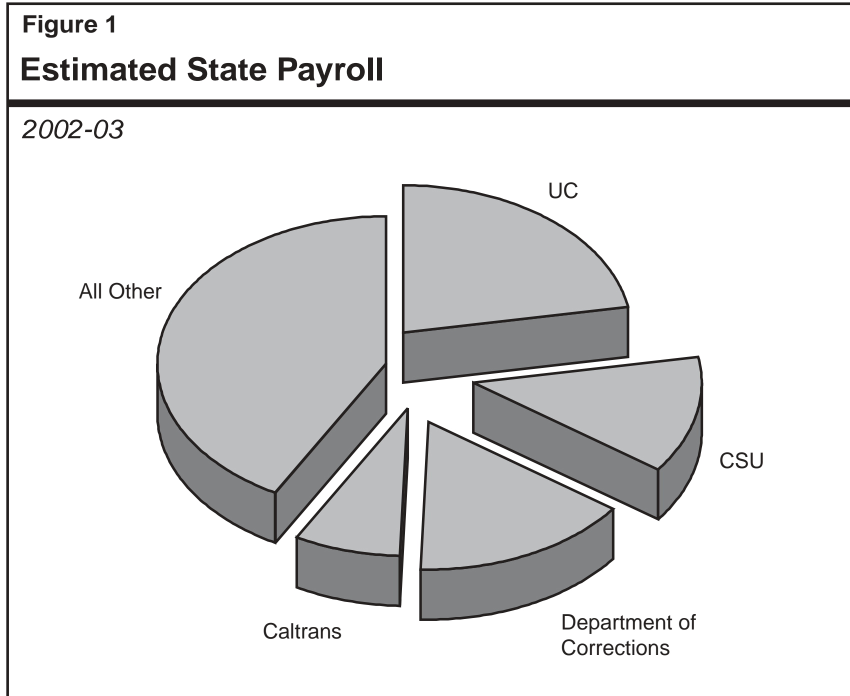


Figure 1

Estimated State Payroll

2002-03

These MOUs include a 5 percent general salary increase effective July 1, 2003 for employees in 19 of the state's 21 collective bargaining units. This offsets the reinstatement of the employee retirement contribution, which is almost 5 percent of salary for most state employees. The administration approved a similar package for supervisors, managers, and other employees not subject to collective bargaining.

Figure 2 (see next page) shows a history of general salary increases for state civil service employees and the consumer price indices for the United States and California since 1991-92.

Longer-Term Contracts for Four Bargaining Units. Most MOUs expire at the beginning of the budget year. Four bargaining units, however, have contracts that extend beyond this period. Specifically, these MOUs stretch through 2003-04 for Unit 12 (Craft and Maintenance) and through

2005-06 for Unit 5 (Highway Patrol), Unit 6 (Corrections), and Unit 8 (Firefighters).

Employees in Unit 8 and Unit 12 also will receive the 5 percent salary increase discussed above. The MOUs for Unit 5 and Unit 6 include the first of four annual pay raises, effective July 1, 2003. The budget-year salary increases are approximately 6 percent and 3.5 percent for Unit 5 and Unit 6, respectively. These multiyear salary increases are designed to eliminate the state's pay differential with particular local law enforcement agencies, as specified in current law. Supervisors and managers of these employees will receive a similar package. By the final pay raise effective July 1, 2006, the cumulative salary increase for employees in the two units is estimated to be approximately 33 percent.

Figure 2

State Civil Service General Salary Increases

1991-92 Through 2003-04

		Consumer Price Indices	
Fiscal Year	State General Salary Increases	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[a]	—	2.2	2.5
2003-04[a]	5.0[b]	2.2	2.5

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

[b] Except for California Highway Patrol and California Correctional Peace Officers Association; which will receive adjustments of 6 percent and 3.5 percent, respectively.

Future Cost of Negotiated Pay Raises Increases Significantly. Figure 3 shows the projected ongoing cost of the negotiated general salary increases through 2006-07, when all pay raises would be fully implemented. These costs are estimated to be $532 million in the budget year, growing to an annual cost of $1.3 billion by 2006-07. More than half of these costs are attributable to the General Fund. As shown in the figure, the key factor driving this growth is the multiyear raises negotiated for the Highway Patrol and correctional officers.

Figure 3

Costs of Negotiated General Salary Increases

All Funds
(In Millions)

	2003-04	2004-05	2005-06	2006-07
Unit 5[a]	$27	$62	$101	$147
Unit 6[a]	73	248	441	680
All other	432	432	432	432
Totals	**$532**	**$742**	**$974**	**$1,259**

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

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

The budget does not include funding for the salary increases effective July 1, 2003 under current MOUs. It is our understanding that this is because of the budget's proposed reduction in employee compensation expenditures to be negotiated for 2003-04, as discussed below. Specifically, it is possible that the negotiated general salary increase may be one part of the proposed reduction package to be determined through collective bargaining. Thus, the Governor's budget does not include this funding.

The budget does propose $12 million for additional cost provisions negotiated in the longer-term MOUs—senior, educational, and flight pay increases for Unit 6 employees ($3.2 million) and overtime-related provi-

sions for employees in Unit 8 ($8.7 million). Almost all this amount—$11 million—is from the General Fund.

Employees in Higher Education. Employees of the UC and CSU systems are not part of the 21 bargaining units discussed above. Instead, they negotiate with the universities to determine terms of employment. The Governor's budget does not propose any additional General Fund expenditures for employee salary and benefit increases, but includes $17.2 million from the General Fund for additional health benefits costs for annuitants.

Reduction in Employee Compensation Expenditures Proposed

The Governor's budget proposes an $855 million ($470 million General Fund) reduction in employee compensation expenditures in the budget year, to be determined through collective bargaining.

Proposed Reduction Equivalent to 8 Percent Salary Cut. The Governor's budget proposes an $855 million ($470 million General Fund) reduction in employee compensation expenditures in 2003-04. The proposal also includes budget control language—Control Section 4.10—authorizing the Director of DOF to reduce departments' budgets to "reflect employee compensation savings either negotiated through the collective bargaining process or as a result of layoffs, furloughs, and other similar personnel actions." The DOF has indicated that these reductions would be negotiated through (1) new MOUs for most bargaining units, with contracts expiring at the beginning of 2003-04, and (2) reopening the longer-term MOUs that do not expire this summer.

The $855 million in savings is roughly equivalent to an across-the-board 8 percent salary reduction. These savings, however, could be achieved through any combination of pay cuts (including deferral of the general salary increases effective July 1, 2003), reduced benefits, or other actions like furloughs or layoffs.

To the extent that any negotiated reductions are not implemented at the beginning of the budget year, greater cuts would be necessary to realize the proposed savings. For example, if salary reductions were not effective until October 1, 2003, the three-month delay would require a 10 percent salary reduction to generate $855 million in savings in the budget year.

Collective Bargaining Process Provides Framework for Determining Cuts

The state's collective bargaining process is governed by the Dills Act. The act requires the state and employee unions to meet and confer in

good faith on employment-related issues at the request of either party. In general, anything that affects terms and conditions of employment is subject to collective bargaining. This includes pay and benefits, as well as all personnel-related actions except layoffs. *Whether* layoffs occur is not subject to negotiation. The state has the freedom to determine the need for layoffs. The MOUs, however, do include provisions for *how* layoffs proceed if they do occur. The Dills Act requires funding for all new expenditures negotiated in MOUs to be approved by the Legislature.

Proposed Budget Language Does Not Include Legislative Oversight

As discussed previously, negotiated pay and benefit reductions, as well as nonlayoff personnel actions, would be adopted in new or revised MOUs. In the past, the Legislature has received MOUs for approval late in the legislative session, after completion of the budget (contrary to provisions of the Dills Act). In these cases, there have sometimes been incomplete or unavailable assessments of the total cost of the MOUs. It will be important for the Legislature to have sufficient time for a meaningful review of the proposed cuts, since securing reductions now may be achieved by negotiating additional benefits—with additional costs—for future years.

In addition, the proposed budget language in Control Section 4.10 includes no approval—or even review—by the Legislature of proposed reductions, despite the significant ramifications the $855 million in savings would have for state employment. Although compensation reductions would be negotiated in new MOUs, the administration could independently determine how much savings to generate through layoffs. Thus, with the Governor's proposed language, the Legislature faces the prospect of approving a total amount of savings in the budget and having no input on the reductions.

Legislative Options for Exercising Control Over Compensation Reductions

The Governor's proposal has the administration leading the determination of employee compensation reductions. Specifically, the administration would negotiate cost-saving provisions with the employee unions, and DOF would reduce departments' budgets accordingly. Given the state's fiscal condition, we believe it is appropriate to consider reductions in employment costs. But the Legislature need not defer to the administration in determining or allocating negotiated reductions. We lay

out below options at key decision points for the Legislature to exercise some control over the proposed $855 million reduction.

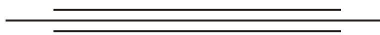
Does the Legislature Want to Cut Compensation Costs? First, the Legislature must determine whether to reduce employee compensation expenditures to help balance the budget, as the Governor has proposed. If not, then the budget requires a $532 million (all funds) augmentation to implement the July 1, 2003 general salary increases.

If the Legislature does opt for compensation reductions, then the desired level of cuts would need to be determined. After considering the programmatic and employment impacts associated with various levels of cost savings, the Legislature could choose whether to approve $855 million in savings, as the Governor has proposed, or some greater or lesser amount.

Establish Parameters for Negotiations? Following a decision to reduce employee compensation expenditures, the Legislature could consider the relative merits and drawbacks of various types of cuts and set parameters to direct the administration's negotiating efforts. For example, the Legislature may wish to focus on savings from particular types of adjustments—for instance, reduced salaries, reduced state contributions for health insurance, and layoffs.

Alternatively, the Legislature may wish to leave the determination of cost-saving provisions entirely to collective bargaining. This would leave to the administration and the unions the determination of how to achieve the proposed savings. This option conforms with the Governor's proposal.

How Much Time to Review? As discussed above, the proposed budget control language includes no legislative review or approval of compensation reductions. However, it will be particularly important for the Legislature to be aware of any additional costs from future provisions negotiated in exchange for savings today. As a result, the Legislature may want to amend the proposed language to add 30-day notification so that the fiscal and policy implications of cuts in employee compensation expenditures can be fully understood.



PRO RATA
(9900)

Pro rata is the recovery of statewide general administrative costs from special funds. Recently, the Department of Finance (DOF) has made a number of changes to the recovery of these costs. We recommend DOF report on the revised methodology.

The DOF is charged with the accurate assessment and recovery of costs incurred by the General Fund to administer state government. Beginning in 2002-03, the DOF made a number of changes to its methodology for cost recovery. We offer our preliminary assessment of these changes below.

Background

What Is Pro Rata? Pro rata is the recovery from special funds of costs incurred by central service agencies for the overall administration of state government. Central service agencies, such as DOF, the State Personnel Board, and the State Controller, provide services to all state departments. The costs of central service agencies are initially paid by the General Fund. The services provided by these agencies benefit not only General Fund programs, but also programs supported by special funds. Consequently, the state recovers a share of the costs from special funds through the pro rata process. The DOF determines the amount of the costs to be recovered and which special funds to charge.

How Are Departments' Overall Pro Rata Costs Determined? The central service agencies report to DOF the amount and cost of workload conducted to support other state departments. Based on this information, DOF determines the costs to be allocated to state departments benefiting from these services. For example, the State Controller manages the payroll system for state departments. The costs of providing these payroll services are distributed to those department benefiting from these services (by their share of total paychecks issued, for instance).

Which Funds Are Billed? Once the amount to distribute to a particular department is determined, this overall pro rata charge is distributed to the various funds in support of that department. At the department level, no effort is made to determine each fund's actual share of workload (such as the number of paychecks by fund). Instead, each fund gets a proportionate share of the total department charge based on its share of total expenditures. The rationale is that each fund would tend to use services in rough proportion to its total expenditures.

For the purposes of pro rata, these funds are then determined either "billable" or "non-billable." The billable funds will reimburse the General Fund for pro rata allocations. Billable funds have special revenue sources such as fees, licenses, penalties, assessments, and interest. For other funds, General Fund appropriations provide the source of revenue. As a result, there is no reason for these non-billable funds to reimburse the General Fund for their share of state administrative costs. So this share of the pro rata charge is not recovered. To the extent that more funds are determined to be billable, the greater the reimbursement to the General Fund.

How Much Is Recovered by Pro Rata? As shown in Figure 1, the costs annually recovered from the special funds are significant—totaling more than $256 million in 2001-02. While the total amount of costs recovered has increased steadily over the past few years, the percentage of costs recovered has consistently remained about 30 percent. In other words, about 70 percent of control agency charges are determined to be non-billable.

Figure 1

Pro Rata Recoveries

(In Millions)

	Administrative Costs	Costs Recovered Through Pro Rata
1997-98	$430.9	$128.5
1998-99	487.6	149.5
1999-00	575.2	175.8
2000-01	639.3	202.0
2001-02	781.0	255.5
2002-03[a]	892.1	293.3
2003-04[a]	1,139.4	344.0

[a] Department of Finance estimates.

Change in Pro Rata Assessment Methodology. In the past, only special funds with state operations appropriations were assessed for administrative costs. Beginning in the current year, DOF notified state agencies that the pro rata plan had been revised to include additional assessments to special funds with local assistance and capital outlay appropriations. The DOF also began charging some bond funds. While these funds have not been assessed in the past, according to DOF, they should have been assessed. Since these additional special funds receive state services from the central service agencies, DOF believes they should share in the cost of these services.

Concerns About the Revised Methodology

Is the New Methodology Reasonable? Changes to the cost recovery methodology can have significant impacts on both the state's bottom line and individual program spending within special funds. Given the complicated and technical nature of pro rata, there are multiple legitimate approaches to developing a methodology. During the course of our preliminary review of the recent changes to the methodology, we identified two concerns, outlined below.

Are Assessments to Bond Funds Appropriate? General obligation (GO) bonds are a form of long-term borrowing in which the state issues debt and pledges its full faith and credit for repayment. These funds are repaid by the General Fund over time. As noted above, DOF has recently begun to charge some GO bond funds for pro rata charges. To date though, DOF has been unable to provide a consistent rationale as to why some bond funds are being charged, but not others. It is unclear to us why these funds would be treated differently than General Fund accounts, which are nonbillable.

How Should Local Assistance Be Charged? We believe it is reasonable for local assistance funds to be charged pro rata. As with other funds, they impose costs on central service agencies for budget oversight, accounting, and other services. However, we are concerned with the method used by the department to determine the *share* of costs to be charged local assistance in relation to a department's other funds.

As with state operations funds, DOF reports that the amount to be assessed to local assistance funds is determined by the amount of the expenditures from the fund. We question whether the value of a local assistance fund is an accurate indicator of costs incurred by central service agencies.

For instance, the California Children and Families Commission is the state's entity for implementing the provisions of Proposition 10, passed by the voters in 1998. While the commission has a number of its own

state operations duties, local assistance dollars also pass through its budget to county commissions. Of the commission's proposed budget expenditures of $572 million, $452 million flows to counties as local assistance. The state commission has an estimated pro rata charge of $4.3 million in 2003-04 for its share of state administrative expenses. The DOF's pro rata methodology allocates 64 percent ($2.8 million) of that amount to the county allocation fund. While the distribution and accounting of funds to counties obviously incurs some state administrative costs, it is unclear to us that a charge based on total dollars is reasonable.

Recommend DOF Report on Methodology. Based on our review of the information provided by DOF, we are concerned with the changes made in the pro rata methodology. We, therefore, recommend that DOF report during the spring and respond to the concerns outlined above.

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 to Jump. . .

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 $1.2 billion to $2.2 billion in the budget year. This includes an increase in General Fund costs of $543 million. The final determination of 2003-04 contribution rates will occur in the spring.

Negative Return, Actuarial Methods Cause Rates to Jump. This large jump in state retirement contributions to PERS is primarily caused by two factors:

- The poor performance of the stock market resulted in a 6 percent loss for pension funds for 2001-02. This follows a 7.2 percent loss for 2000-01. In contrast, PERS assumes an 8.25 percent annual return over the long term for actuarial purposes.
- Under its actuarial methods, PERS will recognize a greater share of recent losses than usual for 2003-04. This keeps the *actuarial* value of the investment fund—which typically "smooths out" the recognition of gains and losses to reduce dramatic fluctuations in contribution rates—within an established "band" of proximity to the fund's actual *market* value.

. . .But Governor's Retirement Proposal Would Zero-Out 2003-04 Contributions

We withhold recommendation on 2003-04 state contribution rates for retirement benefits pending (1) the outcome of the proposed retirement package and/or (2) final determination of budget-year rates.

As we discuss in the "Crosscutting Issues" section of this chapter, the Governor's budget proposes to borrow the funds to pay state retirement contributions through (1) pension obligation bonds or (2) a loan agreement with PERS. In either case, the state would not make any retirement contributions to PERS from operating funds in 2003-04. Thus, the state would realize savings of up to $2.2 billion ($1.2 billion General Fund) in the budget year.

If the Legislature, however, does not approve the proposed retirement package, then 2003-04 contribution rates would rise from their present level, as noted above. As a result, pending the outcome of the proposed retirement package and/or final determination of 2003-04 rates, we withhold recommendation on this item.

FINDINGS AND RECOMMENDATIONS

General Government

Analysis Page

State Retirement Contributions

F-16 ■ **Incurring Debt for Operating Costs Is Ill Advised.** Recommend that the Legislature reject the administration's debt alternatives to pay 2003-04 state retirement contributions. Incurring years of debt to avoid an annual operating expense as a budget-balancing tool is poor fiscal policy.

General Government—Mandates

F-17 ■ **Mandates.** Recommend the Legislature adopt the general policy of either funding its mandate obligations—or eliminating the state's liability for the mandate. We recommend that some mandates be consolidated with the state-county realignment proposal and that all other mandates be repealed, modified, or suspended for the budget year.

Vacant Positions

F-19 ■ **Vacant Positions**. Recommend the Department of Finance provide updated information. Also, recommend deletion of a new proposed control section as it is unnecessary.

State Emergency Telephone Number Account

F-25 ■ **Increase to 911 Surcharge.** Reject fee increase since proposed activities are inconsistent with current law and change the nature of the 911 surcharge.

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Proposition 46 Housing Bond

F-35 ■ **Reduce Administrative Costs**. Recommend reducing a number of proposed administrative costs, resulting in $13 million in additional bond funds being available for housing assistance.

F-35 ■ **Require Budget Detail**. Recommend the California Housing Finance Agency provide documentation on its proposed administrative activities related to the housing bond.

F-37 ■ **Fund Migrant Farmworker Facility**. Recommend appropriation of $6 million in bond funds for the reconstruction of a state migrant farmworker housing facility. This would eliminate the need for future General Fund spending of an equivalent amount and allow the facility to operate in future years.

F-38 ■ **Options for Addressing the Budget Shortfall.** We outline two options for using housing bond monies to help address the budget shortfall—potentially benefiting the General Fund by hundreds of millions of dollars.

Information Technology Governance

F-41 ■ **Information Technology Governance Model.** Recommend proposal be evaluated based on the key objectives of leadership, accountability, and oversight.

State Data Centers

F-47 ■ **Organizational Consolidation Option.** Administration should report on (1) timeframes, (2) potential problems, and (3) estimates of anticipated savings of organizationally consolidating the Health and Human Services Agency Data Center and Stephen P. Teale Data Center.

F-50 ■ **Consolidation of Servers Option.** Administration should report on timeframes and estimates of anticipated savings of transferring servers to state data centers.

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Judges' Retirement System

F-54 ■ **Budget-Year Opportunity for General Fund Savings. Reduce Item 0390-101-0001 by $10 Million.** Recommend that the Legislature reduce the appropriation for the Judges' Retirement System I by $10 million to help address the General Fund shortfall but still leave an adequate reserve.

Secretary for Business, Transportation and Housing

F-56 ■ **Minimal Efficiency From Consolidation. Reduce Item 0520-001-0044 by $39,000**. Recommend reduction to reflect lower amount of state matching fund needed. Further recommend that the Business, Transportation and Housing (BTH) Agency identify additional areas of cost savings as a result of the consolidation with the Office of Traffic Safety and report to the Legislature prior to budget hearings.

F-57 ■ **Staff Level Significantly Larger Than Budgeted.** Recommend the BTH Agency provide workload justification for each of the 13 borrowed positions. Further recommend that any positions not justified be returned to the loaning departments or eliminated.

Labor and Workforce Development Agency

F-59 ■ **Agency in First Year of Operation.** Recommend that the agency report at budget hearings on steps it has taken to meet the goals specified in Chapter 859, Statutes of 2002 (SB 1236, Alarcón), in its first year of operation.

State Controller

F-61 ■ **Fee Revenues Should Replace General Fund Support for the Unclaimed Property Program. Reduce Item 0840-001-0001 by $2.4 Million.** Recommend the Legislature adopt a processing fee to be charged on all approved claims sufficient to cover program administrative costs. This would result in additional General Fund savings of $2.4 million in the budget year and $4.8 million thereafter.

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California Gambling Control Commission

F-63 ■ **$1.5 Billion Increased Revenue Assumption Risky.** Based on a variety of factors, the realization of $1.5 billion in increased revenue resulting from renegotiated tribal compacts is unlikely.

F-65 ■ **Special Distribution Fund—Opportunity for General Fund Savings.** Recommend Legislature use available $88 million in the Special Distribution Fund for programs, currently funded from the General Fund, that address the impact of gambling on communities.

Board of Equalization

F-68 ■ **Sales Tax Simplification.** Recommend Board of Equalization (BOE) report at hearings regarding fiscal and other impacts of participating in Streamlined Sales Tax Project and adopting the project's multistate agreement.

F-79 ■ **Cigarette Tax Evasion: Federal Action.** Recommend that the Legislature memorialize Congress to enact measures that facilitate collection by states of the cigarette excise tax.

F-82 ■ **Cigarette Tax Evasion: State Enforcement.** Recommend BOE report at hearings regarding revenues that would be received from additional enforcement activities.

Secretary of State

F-83 ■ **Funding for Vacant Positions Not Justified. Reduce Item 0890-001-0228 by $200,000.** Recommend denying augmentation request since no workload data have been provided.

F-84 ■ **Set Fee Equal to Costs.** Recommend that the filing fee for common interest development associations be reduced from $30 to $5 to reflect identified workload.

Franchise Tax Board

F-85 ■ **E-Filing Requirement for Tax Practitioners. Reduce Item 1730-001-0001 by $140,000.** Recommend that the budget proposal

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requiring E-filing for all tax practitioners filing 100 or more returns be expanded to require E-filing for those filing 50 or more returns.

F-85 ■ **Tax Practitioner Services.** Recommend that the department investigate the funding of the Tax Practitioners Hotline by establishing a fee for this service.

F-87 ■ **Integrated Nonfiler Threshold.** Augment Item 1730-001-0001 and recognize additional General Fund revenue of $4.4 million. Recommend lowering the estimated tax threshold for integrated nonfiler compliance program from $200 to $100 and realize additional revenues.

F-88 ■ **Treasury Offset Program.** Recommend that the department investigate the effectiveness of the Treasury Offset Program and its possible benefits for tax collection efforts.

Department of General Services

F-90 ■ **Employee Parking Lot.** Withhold recommendation on $233,000 expenditure authority increase pending outcome of federal waiver.

State Personnel Board

F-92 ■ **No Information on Proposed General Fund Cut.** Withhold recommendation on the requested reduction of $3.8 million General Fund and 57 positions, pending receipt of detailed information on the proposed cuts.

Housing and Community Development

F-96 ■ **Eliminate Regional Planning Mandate for Cities and Counties**. Recommend the elimination of the regional planning mandate for cities and counties since it provides broad discretion on effort and does not ensure compliance with state law. This would result in reduced state liabilities of approximately $2 million annually.

F-97 ■ **Suspend Mandate for Regional Governments.** Recommend the suspension of the regional planning mandate for councils of government, pending the enactment of legislation to reform the housing element process. This would result in reduced liabilities of roughly $700,000.

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Stephen P. Teale Data Center

F-98 ■ **Direct Data Center to Prepare Rate Reduction Proposal. Reduce Item 2780-001-0683 by $6.9 Million**. Recommend reducing an equipment proposal by $6.9 million since the estimate is based on past workload growth trends, which are not reflective of 2003-04 service demand. Recommend the Stephen P. Teale Data Center report at budget hearings on reducing its costs and lowering its rates.

F-99 ■ **California Home Page Spending Increase. Reduce Item 2780-001-0683 by $453,000**. Recommend reducing a proposal to increase spending for the Home Page by five positions, due to the lack of workload data.

Technology, Trade, and Commerce Agency

F-103 ■ **Film Permit Subsidy Program. Reduce Item 2920-111-0001 by $8.2 Million and Item 2920-001-0001 by $0.3 Million. Revert $2 Million in Item 2920-101-3005.** Recommend elimination of the film permit subsidy program and three related positions in the Film Commission because the program has an unclear rationale and a questionable impact on film location decisions. Further recommend that remaining monies in the fund be reverted.

F-104 ■ **Foreign Trade Offices. Reduce Item 2920-012-0001 by $3.4 Million.** Recommend that the Legislature eliminate all trade offices—five contract offices and seven state-staffed foreign trade offices—because they have questionable effectiveness.

F-106 ■ **Agency Size Warrants Department Status.** Recommend that the Legislature adopt trailer bill language returning the agency to department status, given the agency's small size relative to the state's other agencies and its department-like duties.

F-111 ■ **California Technology Investment Partnership (CalTIP) Is Not a Cost-Effective Use of General Fund Resources.** Recommend that the Legislature approve the proposed deletion of funding for CalTIP grants and the regional technology agencies (RTAs) in the 2003-04 budget. Further recommend enactment of legislation to eliminate the grant program and the RTAs as state-created entities because the program's job and tax revenue impact does not justify its state costs.

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Health and Human Services Agency Data Center

F-113 ■ **Deny Equipment Proposal and Direct Data Center to Report on Steps to Reduce Costs and Rates. Reduce Item 4130-001-0683 by $4.7 Million**. Recommend rejecting an equipment augmentation since the estimate is based on past workload growth trends. Direct Health and Human Services Agency Data Center (HHSDC) to report at hearings on actions it will take to reduce costs and rates. Direct HHSDC to report at hearings on status of requested rate study.

F-115 ■ **Deny Operational Recovery Proposal. Reduce Item 4130-001-0683 by $1.2 Million**. Recommend denying request since proposal is inconsistent with Feasibility Study Report and HHSDC did not examine all viable options.

F-116 ■ **Proposed Budget Bill Language Unnecessary**. Delete proposed budget bill language since HHSDC already has budget bill language that addresses unanticipated workload needs.

F-117 ■ **Reduce Child Welfare Services/Case Management System (CWS/CMS) Maintenance and Operation Request. Reduce Item 4130-001-0632 by $11 Million**. Reduce request and direct HHSDC to submit a revised request that finances all proposed hardware.

F-118 ■ **Competitive Procurement for Primary CWS/CMS Contract.** Adopt budget bill language that requires HHSDC to examine competitive procurement options prior to amending the current CWS/CMS contract.

Employment Development Department

F-119 ■ **Work Force Investment Act Discretionary Funds**. The Governor's budget proposes to use most of the available Workforce Investment Act (WIA) discretionary funds to support existing programs and the Nurses Workforce Initiative.

F-121 ■ **Reed Act Funds Available for Benefit Payments and Administrative Improvements.** In April 2002, California received a "Reed Act" Distribution of $937 million. We review the allowable uses and expenditure plans for these funds.

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Department of Industrial Relations

F-126 ■ **New Activities and Uncertain Workload Do Not Justify Entire Request. Reduce Item 7350-001-3030 by $249,000 and Item 7350-001-0223 by $84,000.** Recommend that the Legislature approve $510,000 and six positions for anticipated vocational rehabilitation workload on a two-year limited-term basis. For other activities required by Chapter 6, further recommend (1) deletion of $333,000 and two positions for absorbable or uncertain workload and (2) approval of $749,000 in contract funds on a one-time basis.

F-129 ■ **Option to Defer Some Requests.** If the Legislature would like to further limit the cost of this proposal in response to the state's fiscal condition, there are $3 million in additional savings (beyond our recommendations) that could be achieved by deferring some requests to see if anticipated workload materializes and by relying on existing fraud and workplace safety programs.

Department of Personnel Administration

F-131 ■ **Need for Staff to Process Layoffs Unclear at This Time.** Withhold recommendation on the $1.8 million General Fund proposal for 29 one-year limited-term positions to process 10,000 layoffs, pending legislative decisions on programmatic and compensation reductions that will solidify the likely number of layoffs.

California Department of Food and Agriculture

F-133 ■ **Animal Control State Mandate.** Recommend the Legislature ask the Joint Legislative Audit Committee to review claims involved with the animal control mandate. Pending receipt of this audit, we further recommend that the Legislature (1) not fund anticipated claims bill expenses for this mandate (approximately $79 million) and (2) suspend the mandate in the budget year (resulting in avoided costs of roughly $14 million).

F-137 ■ **Industry Should Contribute to Medfly Control. Reduce Item 8570-001-0001 by $8.9 Million.** Recommend the enactment of legislation authorizing the department to assess the agricultural industry through fees for the nonfederal cost of the Medfly Preventative Release Program.

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California Consumer Power and Conservation Financing Authority

F-140 ■ **Authority Has Not Achieved Financial Self-Sufficiency.** Withhold recommendation on the California Consumer Power and Conservation Financing Authority's (CPA's) support budget pending receipt and review of two reports from the authority that should provide information on CPA's plans to implement its mission and become financially self-sufficient.

Department of Veterans Affairs and Veterans' Homes of California

F-142 ■ **Fee Increase for Veterans' Home Residents. Reduce Item 8960-011-0001 by $290,000, Item 8965-001-0001 by $91,000, and Item 8966-001-0001 by $94,000.** Recommend approval of the Governor's proposal for a 7.5 percent fee increase for residents of the domiciliary care wings of the state' veterans' homes. Also recommend extending the 7.5 percent fee increase to veterans in nursing beds and increasing monthly payment limits for all veterans' home residents.

F-146 ■ **Increase Medi-Cal Eligibility for Veterans' Homes Residents.** Recommend that the Legislature direct the Department of Veterans Affairs (DVA) to report during budget hearings on the feasibility of providing financial planning services to residents entering the veterans homes that may help them become eligible for Medi-Cal benefits. We also recommend the DVA report on the costs and benefits of such an approach.

Tax Relief

F-151 ■ **Williamson Act Program.** Recommend the Legislature provide for the phaseout of the program instead of ending state subventions immediately, as proposed by the Governor.

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Health and Dental Benefits for Annuitants

F-152 ■ **Budget-Year Costs Not Yet Completely Determined.** Withhold recommendation on the $660 million General Fund request for annuitant benefits pending final determination of health insurance premium rates for calendar year 2004.

Augmentation for Employee Compensation

F-154 ■ **Employee Pay and Benefit Increases.** The budget does not include funding for the general salary increases—5 percent for most state employees—effective July 1, 2003, as negotiated in current memoranda of understanding. The budget, however, does include $12 million ($11 million General Fund) for some additional cost provisions negotiated in two contracts.

F-158 ■ **Reduction in Employee Compensation Expenditures Proposed.** The Governor's budget proposes an $855 million ($470 million General Fund) reduction in employee compensation expenditures in the budget year, to be determined through collective bargaining.

Pro Rata

F-161 ■ **Pro Rata Recovery of General Administrative Costs.** We recommend the Department of Finance report on their revised pro rata assessment methodology.

Control Section 3.60

F-166 ■ **Governor's Retirement Proposal Would Zero-Out 2003-04 Contributions.** Withhold recommendation on 2003-04 state contribution rates for retirement benefits pending (1) the outcome of the proposed retirement package and/or (2) final determination of budget-year rates.