Mac Taylor
Legislative Analyst

January 30, 2009

2009-10 Budget Analysis Series

General Government

CONTENTS

EXECUTIVE SUMMARY

This report discusses some key issues facing the Legislature in the general government section of the budget. The state's dire fiscal condition means that the Legislature may need to reject or defer funding for many general government programs in order to help balance the budget.

Balancing the 2009-10 Budget

Employee Compensation Reductions. The Governor's proposal includes various measures to reduce state personnel costs, including a two-day-per-month furlough of nearly all state workers (with an accompanying pay reduction of about 9 percent through June 2010) and a limited number of layoffs. The proposals would result in an 11 percent drop in General Fund personnel costs and savings of $1.7 billion over the next 17 months. We believe that employee compensation reductions are necessary due to the magnitude of the budget problem. Nevertheless, we observe that the administration's plans—especially savings from the furlough—will be difficult to achieve. Such large reductions probably cannot be achieved through the collective bargaining process without resulting in costly future pay or benefit promises for employees that the state cannot afford to make.

Budget Overspends on Inflation. The Governor's budget includes a 3.2 percent inflationary adjustment for state departments' operating expenses. This adjustments results in a General Fund cost of $136 million in 2009-10. Due to the sagging economy and falling energy prices in recent months, our forecast for inflation is much lower—0.4 percent in 2009-10. We recommend the Legislature reject the price increase and direct departments to absorb any increases in operating expenses.

Increase State Revenues by Making Changes to Tax Programs. In order to generate additional tax revenue, we describe ways to change the administration of tax collection at the Franchise Tax Board (FTB) and the Board of Equalization (BOE), and to modify California's tax laws relative to federal laws. Combined, these changes would result in increased General Fund revenues in the low hundreds of millions of dollars over time.

Reject Funding Most of the Governor's Emergency Response Initiative. The 2009-10 budget proposes increased spending in the California Emergency Management Agency of about $18 million to enhance the state's emergency response capabilities and $2 million in the Military Department for aviation firefighting equipment. These new expenditures would be funded by an insurance surcharge. We recommend against funding most of these expenditures because they do not address a critical and immediate need.

Other Issues

Unemployment Insurance (UI) Fund Faces Insolvency. The UI fund is facing insolvency and, absent corrective action, would remain insolvent for the foreseeable future. The Governor proposes to restore solvency—largely by increasing the taxes employers pay for each covered worker. We find that the Governor's approach has merit because it restores solvency and the proposed employer tax burden would be near the median for all states. We also recommend eliminating the Employer Training Tax to partially offset the Governor's proposed UI employer tax increase.

Retirement Costs to Increase. The budget assumes roughly 10 percent growth in General Fund retirement costs, with retiree health and dental costs being the fastest-growing component. The outlook for the state's pension contributions after the budget year is grim. Large investment losses in the state's pension systems during 2008-09 are likely to result in significant new unfunded liabilities that may increase state costs by hundreds of millions of dollars per year beginning in 2010-11.

Major Information Technology Projects Face Challenges. Both the 21st Century Project—which would modernize the state's payroll system—and the Financial Information System for California (FI$Cal)—which would replace the entire state's aging automated fiscal systems—are facing significant difficulties. Regarding the 21st Century Project, we recommend that the Legislature carefully consider whether the risks and costs associated with completing the failed work of a prior vendor by hiring a new vendor (as proposed) outweigh the costs of starting clean on the software configuration portion of this project. With respect to FI$Cal, we recommend that the Legislature delay the release of the proposed request for vendor bids by at least six month and consider reducing the initial scope of the project.

Indian Gaming Special Distribution Fund (SDF). As a result of recently amended compacts between the state and tribes that own some of the state's major casinos, revenues of the SDF have dropped dramatically. This has produced a structural deficit in the fund that the Legislature will need to address over the next few years. We make recommendations designed to limit future pressures on the General Fund to pick up existing SDF costs.

BACKGROUND

The general government section of the budget contains a number of programs and departments with a wide range of responsibilities and functions. Some departments provide services to the public (such as emergency services, housing, and regulation of various industries) and other departments provide internal state functions (such as providing information technology and financial services). In addition, this part of the budget includes costs to pay state workers' salaries and benefits. In this report, we discuss the key general government issues facing the Legislature.

BALANCING THE 2009-10 BUDGET

Employee Compensation

Currently, the state workforce consists of approximately 363,000 personnel years (PYs). (A PY is roughly equivalent to one full-time equivalent employee.) Total state payroll, including university personnel, is now roughly $24 billion per year. Of the 363,000 PYs, just over one-third are employed by the state's two public university systems. Excluding university employees, around $11 billion of General Fund expenditures—about 11 percent of the budget in the *2008-09 Budget Act*—relate to state personnel costs, including payroll and state contributions to employee pensions, health, and other benefits.

Overview: Governor Proposes Substantial Cuts in State Personnel Costs

Various Measures to Reduce Employee Costs—With Almost No Raises—Under Governor's Plan. Under the Governor's budget, very few state employees—specifically, California Highway Patrol (CHP) officers and almost no others—would receive a general salary increase in 2009-10. The Governor also proposes major decreases in state personnel spending to help balance the budget. Specifically, the Governor proposes that the Legislature approve:

- A two-day-per-month furlough of nearly all state workers (principally, excluding CHP officers) and an accompanying 9.2 percent reduction in their monthly pay beginning in February 2008 and ending in June 2010. (While the Governor is attempting to implement the furlough and other changes through an executive order—now subject to legal challenges—the administration also has requested statutory authority to implement the furlough and other measures outside of the collective bargaining process. In this piece, we mainly consider the statutory proposal.)
- Elimination of two state holidays and an existing policy to pay most employees more when they work on other holidays.
- A statutory requirement to require that overtime payments be made to state workers based on actual time worked rather than on other calculations that have been used for some groups of employees.
- A measure authorizing the administration to negotiate directly with health plans and

providers for health coverage for state workers and retirees. The measure would remove this authority from the California Public Employees' Retirement System (CalPERS) beginning in January 2010.

In addition to the proposed legislative actions, the administration also has initiated steps to lay off up to 10 percent of state employees paid from the General Fund. (The administration has existing statutory authority to initiate layoffs.) The budget proposal reflects $150 million of General Fund cost savings from these layoffs in 2009-10. Its savings estimate corresponds to only about 1.5 percent of General Fund employees.

All but One of the State's Collective Bargaining Agreements Have Expired. While 20 of the state's 21 bargaining unit agreements have expired—with the one exception being the CHP officers' agreement, which expires in July 2010—the law generally provides that provisions of prior agreements, or memoranda of understanding (MOUs), continue in effect (at least until the state and the union reach an impasse in negotiations). Accordingly, certain provisions of expired agreements—mainly, those providing for increased state contributions to employee health benefits—continue to generate higher state costs.

In Total, a Proposed 11 Percent Drop in General Fund Personnel Costs in 2009-10. Figure 1 shows the net General Fund savings of the various Governor's employee compensation proposals. The Governor's proposal (through Item 9800 of the budget) would provide $122 million ($45 million General Fund) to cover estimated departmental cost increases under provisions of various collective bargaining requirements in 2009-10. Increased health, dental, and vision contributions under expired MOUs—assuming a typical rate of annual growth in CalPERS plan premiums for 2010—account for over 60 percent of the proposed General Fund costs in Item 9800.

In addition, the Governor has submitted trailer bill language to implement his employee compensation savings proposals, including several proposals that would enact changes notwithstanding existing statutory requirements that they be negotiated with unions through collective bargaining. The administration also proposes that the Legislature include Control Section 3.90 in

Figure 1

Governor Proposes Huge Reductions in State Employee Costs[a]

(General Fund, In Millions)

	2008-09	2009-10
Budget Act Item 9800—Increased employee costs, mainly for employer health contributions in 2010	—	$45
Two-day-per-month state employee furlough	-$376	-902
Elimination of two holidays and premium pay for holidays	-26	-74
Overtime calculated based on actual time worked	-13	-30
State employee layoffs	—	-150
Move health care negotiations from CalPERS to the administration	—	-132
Totals	**-$415**	**-$1,244**

[a] Does not reflect other reductions in personnel costs included in departmental budgets as policy proposals—for example, proposed changes in prison and parole policies.

CalPERs = California Public Employees' Retirement System.

the *2009-10 Budget Act*, which would give the administration the authority to capture the proposed savings outlined in Figure 1 from departmental employee compensation budgets after passage of the 2009-10 budget package. In total, the proposals would result in a *net reduction* of state personnel costs by $1.9 billion ($1.2 billion General Fund) in 2009-10, compared to the administration's workload budget. In addition to these cost reductions, implementation of the administration's proposals beginning in February 2009 would reduce 2008-09 personnel costs by $698 million ($415 million General Fund)—principally as a result of savings from the furlough proposal. General Fund personnel costs would be reduced by about 11 percent in 2009-10 under the administration's proposal.

Cuts of a Similar Magnitude in Special Funds Personnel Costs. Most special funds also would see personnel cost reductions approaching 10 percent over the same time period. While most special funds do not face a deficit like that of the General Fund, it is necessary to implement pay reductions or furloughs across all funds in order to prevent employee migration from one state department to another.

Employee Compensation Cuts Necessary, but Administration Plans Will Be Difficult to Achieve

A Budget Deficit So Large Requires Cuts in the Personnel Budget. With a budget gap as large as the one now facing the state, it is almost impossible to imagine a budget solution that does not involve some level of reductions in state employee costs. As described above, state employee costs equal around 11 percent of the existing General Fund budget, making this too large an expenditure category to ignore when fashioning a solution to this year's monumental deficit. We conclude that the administration's targeted General Fund personnel cost reductions of $415 million in 2008-09 and $1.2 billion in 2009-10 represent a reasonable attempt to generate savings in this expenditure category.

More Detail Needed on Furlough to Ensure Real Cost Savings Are Possible. While we acknowledge the need for difficult measures to reduce General Fund employee costs over the next 17 months, the administration's proposals still lack many important details. For many departments, closing offices on the first and third Fridays of each month—as the Governor has directed in connection with his furlough executive order—could work as a cost-saving measure. These reduced employee hours would result in diminished services received by the public. For 24-hour institutions such as state hospitals and prisons, however, the administration apparently intends to give workers two more days a month of leave time. It is assumed that the leave would be accumulated by workers and used *as a substitute for* paid vacation time. In other words, the assumption is that workers at these institutions will take as many days off as they otherwise would—just that 34 of those days (two days per month times 17 months) will be furlough days and not paid vacation days. If, on the other hand, employees at 24-hour institutions take the time off they ordinarily would for paid vacation and, *in addition*, take their furlough days off, this would mean that other workers would have to work for more hours—often earning overtime—to cover for the employee's extra leave time. While departmental budgets include a baseline amount to cover expected overtime costs, institutional budgets do not include funds to cover extra overtime costs in this particular scenario.

Alternatively, state hospitals, prisons, and other institutional facilities could alter shifts and scheduling arrangements to account for the possibility that average daily staffing levels would be reduced because of the furloughs. This option, however, could affect health and safety at these institutions and run afoul of court or consent-decree requirements for staffing.

Recommend Asking Administration to Expand on Furlough Proposal. Because of the issues described above, we recommend that the administration be asked to describe their exact plans in *each* 24-hour department to ensure that furloughs would result in real cost savings—rather than increased overtime costs that would offset the budgeted savings or potential compromises of employee, inmate, or resident health and safety.

Achieving Such Large Cuts Probably Requires Legislative Action— Not the Collective Bargaining Process

Collective Bargaining Is Largely a Process of Quid Pro Quo. Rank-and-file state employees do not have a constitutional right to bargain collectively through their unions concerning terms and conditions of employment. The Legislature, instead, established collective bargaining in a 1977 statute known as the Ralph C. Dills Act. The Dills Act established requirements that the administration—through the Department of Personnel Administration (DPA)—meet and confer in good faith with unions chosen by employee bargaining units to represent them. The unions also must meet and confer in good faith. Through negotiation, the parties reach agreement on MOUs that spell out key terms of employment, including salary increases and benefits. Those agreements also must be approved by members of the bargaining unit itself, and key provisions—especially those requiring the expenditure of funds—must be approved by the Legislature in order to take effect. Nearly three decades of state operations under the Dills Act have shown that the employee collective bargaining process is one of give and take, where concessions from one side at the bargaining table must be matched with benefits offered from the other party. Collective bargaining inevitably involves a quid pro quo between employer and union—one thing in exchange for another.

Right Now, the State Has Little or Nothing to Give Employees in Exchange for Large Cuts. The administration has proposed that its employee compensation package, including the furloughs, be authorized by the Legislature outside of the collective bargaining process. Because the Legislature created the state employee bargaining process through statute, it also can change the process through statute. For example, the administration proposes that its furlough proposal for rank-and-file employees be authorized in statute "notwithstanding the Ralph C. Dills Act . . . or any other provision of law." Furthermore, through Control Section 3.90, the administration proposes that the Legislature give the administration authority to reduce departmental appropriations to reflect these proposals—thereby reducing appropriations for parts of existing or prior MOUs that conflict with the furlough, holiday, and premium pay proposals. The Dills Act requires the Legislature to provide appropriations for any provision of an MOU requiring the expenditure of funds. Since passage of the Dills Act, however, there is little or no precedent for the Legislature approving such large reductions in appropriations for state employee costs outside of collective bargaining. Therefore, the administration's proposals represent a sharp change from past state policy. Given the circumstances, however, we believe that the proposal is appropriate because the state has little of value that it could give unionized employees in exchange for such large cuts. Accordingly, it would be virtually impossible to achieve agreements with unions in the timeframe necessary to achieve the budgeted savings (as well as quick reductions in state spending to help the state's cash flow situation). Moreover, even if the state and unions reached such agreements, they could probably do so only with promises that the employees receive something valuable—pay raises, benefit increases, or other changes likely to increase state costs—within a few years. The state's current and structural budget deficits are so massive that we must advise the Legislature to reject bargaining agreements that secure cost savings now in exchange for substantial cost increases later. The administration, we believe, is correct to propose one-time exceptions from the Dills Act process to implement these emergency budget measures.

Layoffs Are a Blunt Tool and Should Be a Relatively Minor Part of the Budget Solution

Administration Assumes Relatively Little Savings From Statewide Layoffs. State law gives the administration broad power to lay off state workers for lack of work or lack of funds, provided that a lengthy statutory process is followed to ensure that more junior workers are the ones most likely to be affected by the layoffs. On December 19, 2008, the Governor ordered DPA to work with departments to begin the process "to initiate layoffs and other position reduction and program efficiency measures to achieve a reduction in General Fund payroll of up to 10 percent." The order also directed departments to deliver "surplus" notices to General Fund employees in the bottom 20 percent of seniority, which is a necessary precursor to laying off some of these workers. Despite these directives, the Governor's 2009-10 budget plan assumes relatively modest General Fund savings from layoffs—just $150 million, which equates to only about 1.5 percent of General Fund personnel costs.

Targeted Layoffs Set by the Legislature Are Preferable to Broad-Based Layoffs From the Administration. While the administration's other proposed employee compensation savings measures are painful and difficult for state employees and their families, we agree with the administration's effort to prioritize other savings initiatives over broader, statewide layoffs. Pay cuts could hurt recruitment and retention of employees, but broad-based layoffs could seriously reduce employee staffing in departments. Because such layoffs might be administered by the executive branch alone, the departments most affected might run counter to the Legislature's priorities concerning programs and services. Should the Legislature wish to pursue greater cost savings through layoffs, we advise picking particular programs that are deemed to be lower priority and reducing expenditures in those particular programs. Layoffs resulting from that kind of targeted legislative action would best reflect the Legislature's priorities.

Moving Health Plans Out of CalPERS Worth Considering . . . But Governor's Plan Unlikely to Produce 2009-10 Savings

Governor Proposes That Employee and Retiree Health Plans Be Managed Within the Administration. The Legislature determines policies concerning state employee and retiree health benefit programs. Currently, through the Public Employees' Medical and Hospital Care Act (PEMHCA), the Legislature vests responsibility for managing PEMHCA health care programs for state workers, state retirees, and employees or retirees of participating local agencies with CalPERS. The Governor's budget plan includes trailer bill language that would amend PEMHCA to allow—in addition to CalPERS—"another authorized entity of the state" (presumably DPA) to offer such plans. Further, the budget plan assumes that, effective January 1, 2010, the state—by moving health plan negotiations from CalPERS to DPA—would be able to achieve a 10 percent reduction in the share of health premiums that the state pays for its employees and retirees. These savings would total $180 million ($132 million General Fund) in 2009-10, the administration estimates, and would be applied to addressing the 2009-10 budget problem. In the *2009-10 Governor's Budget Summary*, the administration indicated its intent that, beginning in 2010-11, such savings be applied to addressing the state's unfunded retiree health liabilities—which were estimated to be $48 billion in 2007.

Moving Health Plan Administration to Within the Administration Is Worth Considering. Our office proposed moving health plan administration from CalPERS to DPA in 1985. At the time, we noted that DPA administered virtually all of the state's employee benefit programs, which is still true. In our *Analysis of the 1985-86 Budget Bill*, we wrote that "we can find no convincing reason why the CalPERS board, an independent entity having no *overall* responsibility for the negotiation and administration of state employee benefits, should be in charge of this one major benefit." Furthermore, having an independent entity manage health plans means that the state department in charge of coordinating personnel policy has only a token say (the DPA director sits on the CalPERS board) in how these plans structure and offer benefits. In effect, by delegating such vast power to the independent CalPERS board, the Legislature has diminished substantially its ability, through DPA, to direct state personnel health policies and costs. We continue to believe that exploring a move of health benefit programs from CalPERS to DPA makes sense.

Nevertheless, Achieving Large Changes and Cost Savings by January 2010 Is Unlikely. While we are supportive of the administration's general approach, we are skeptical that a transition of the administration of health plans involving hundreds of thousands of state employees and, perhaps, local employees enrolled in PEMHCA can be achieved within a one-year timeframe. Moreover, the administration assumes huge cost savings that would, by necessity, involve large "cost-shifting" (through increased copayments, deductibles, or similar changes) from the state to employees and retirees. The Governor's proposal offers no meaningful detail on what changes would be implemented in health plans to achieve these considerable savings by January 2010.

Major Changes Proposed for State Retiree Health Vesting for Future Hires

Most State Workers Now Vest in These Benefits Within 20 Years. In our February 2006 publication, *Retiree Health Care: A Growing Cost for Government*, we described the comprehensive retiree health benefits that the state provides to its workers as deferred employee compensation for their years of service. In our report (see page 4), we noted that state employees hired prior to 1985 generally are fully vested for health benefits upon their retirement after a career of service with the state. Most state employees hired since 1985 receive no state contributions for retiree health benefits until they reach ten or more years of service. These workers receive 50 percent of the maximum state contribution with ten years of service, increasing 5 percent annually until they are eligible to receive 100 percent of the maximum state contribution after 20 or more years of employment.

Governor Proposes Lengthening Retiree Health Vesting Period to 25 Years. Trailer bill language accompanying the Governor's budget plan proposes to lengthen the retiree health vesting period for state, CSU, and judicial employees hired beginning on July 1, 2009, to 25 years. The proposed statute would provide that these future hires "may not receive *any* portion of the employer contribution" for retiree health care "unless he or she is credited with 25 years of state service at the time of retirement." This would be a significant change in retiree health benefits accrued by new hires. Currently, Item 9650—which pays for the state's contributions to CalPERS to cover the cost of retiree health benefits—is one of the fastest-growing budget items, and the state's unfunded accrued liability for these benefits was estimated at $48 billion in 2007. While the proposed change would result in *no* cost savings for the state for the foreseeable future, it could reduce Item 9650 costs substantially over the long term.

Other Options for the Legislature to Change Retiree Health Vesting. We believe that the administration's proposed changes to vesting have merit. Requiring future hires to work for an entire 25-year period before receiving *any* state contributions for retiree health benefits, however, is a fairly significant change. More modest changes could be enacted as an alternative: for example, allowing workers to receive a reduced benefit after 15 or 20 years of service, with that benefit increasing each subsequent year until the full state contribution is provided after 25 years of service.

Budget Overspends on Inflation

Proposed Increase for Rising Costs Unnecessary

Governor's Budget Proposes 3.2 Percent Increase. In a typical year, a department's operating expenses will tend to increase due to inflation. For instance, rent, utilities, and transportation expenses rise over time. To allow departments to pay for these rising costs without reducing other services, the administration usually builds a "price increase" into the Governor's budget. The *2009-10 Governor's Budget* includes a 3.2 percent inflationary adjustment for operating expenses. This adjustment results in a General Fund cost of $136 million in 2009-10. Of this amount, two-thirds ($93 million) is for the California Department of Corrections and Rehabilitation (CDCR).

Inflation Projections Dropping Rapidly. In August 2008, when the administration decided to build in the price increase for the upcoming 2009-10 budget, a projection of 3.2 percent for inflation was reasonable. In recent months, however, the sagging economy and falling energy prices have made the forecast for inflation much lower. We now project that inflation for government expenses will amount to only 0.4 percent in 2009-10. *Given a projection of such modest inflation, we recommend that the Legislature delete the price increase and simply have departments absorb any increased operating expenses. This action would reduce proposed General Fund expenditures by $136 million.*

Increase State Revenues by Making Changes to Tax Programs

The Legislature can increase net tax revenues by improving the state's ability to deter tax noncompliance, by reducing the cost of tax administration, and by making changes to how the state conforms with federal tax laws. Below, we estimate that implementing a number of these changes at FTB and BOE would increase General Fund revenues in the low hundreds of millions of dollars annually. Specifically, our recommendations include:

- ***Administrative Changes.*** We have identified various administrative changes that could improve BOE's and FTB's ability to collect taxes due to the state. We estimate that making these changes would increase General Fund revenues by $34 million in 2009-10, increasing to more than $100 million in annual net General Fund revenues in future years.
- ***Penalties and Interest.*** We estimate that making the proposed changes to penalties and interest charges assessed would increase General Fund revenues by $7 million in 2009-10, increasing to more than $22 million in annual net General Fund revenues in future years. In addition, there would likely be greater revenues that would result from the deterrent effects of increased penalties and fees.
- ***User Fees.*** We estimate that increasing user fees would result in greater General Fund revenues of $4 million annually beginning in 2009-10.
- ***Federal Conformity.*** We estimate that making two changes in how state tax law conforms to federal tax law would increase General Fund revenues by $35 million in 2009-10, increasing to about $50 million annually beginning in 2010-11.

Figure 2 summarizes the recommendations that we discuss below.

Administrative Changes Would Improve the Collection of Taxes

Below, we discuss many administrative changes that we recommend making at FTB and BOE to improve the collection of taxes.

Increase Access to Information About Taxpayer Assets. The FTB lacks access to information about taxpayers' accounts at financial institutions. This information is one of the three most reliable sources of data about taxpayer assets that could be used for the collection of unpaid tax debts. The FTB already has access to the two other sources of information—real property records and wage and payment reporting. The financial institutions records match (FIRM) system proposed last year by FTB (but not included in the Governor's budget) would provide FTB information about taxpayers' accounts at financial institutions. It would require financial institutions doing business in California to match delinquent income tax and non-tax debtors' information from FTB against customer records on a quarterly basis. The FTB's proposal also would reimburse financial institutions $100 for each match related to their costs in providing the information. This would better enable FTB to seize assets for the payment of tax debts and thereby increase state revenues. We recommend that the Legislature direct FTB to implement FIRM. The FIRM system would result in General Fund revenues of $35 million in 2009-10, increasing to more than

$100 million in annual net General Fund revenues by 2011-12. The FTB estimates ongoing costs of about $2.2 million to implement FIRM.

Impose Liens Earlier in the Collection Process. The FTB and BOE send taxpayers a notice of collections after (1) the taxpayer has exhausted all appeals rights and (2) contact with the taxpayer during the audit and collections processes was ineffective at resolving the tax debt. State law then allows—60 days after the notice of collections has been sent to the taxpayer—FTB and BOE to apply a lien on the taxpayer's property. A tax lien is a legal claim on property to secure the payment of taxes. The FTB applies a lien after 60 days when the tax debt is $1,000 or more. The BOE, however, in most cases waits 180 days before applying a lien, and only when the tax debt is $2,000 or more. The FTB believes that applying a lien more quickly and to a minimum debt of $1,000 allows it to more effectively seize assets, if necessary, for the payment of tax debts. We recommend that the Legislature require BOE to apply a tax lien 60 days after a collections notice has been sent to the taxpayer and decrease its minimum threshold of tax debt owed to $1,000 in order to increase the collection of taxes owed. The fiscal benefit is unknown, but probably in the range of $1 million annually.

Figure 2

Tax Administration Reforms and Federal Tax Conformity Recommendations[a]

(General Fund Benefit, in Millions)

	2008-09	2009-10	2010-11	2011-12
Administrative Modifications				
Implement financial institutions records match system	—	$33.0	$61.0	$101.0
Faster use of liens in collections process	—	1.0	1.0	1.0
Comply with federal withholding requirement[b]	—	—	26.0	1.0
Subtotals Administrative Modifications	(—)	($34.0)	($88.0)	($103.0)
Penalty and Interest Modifications				
Penalize "baseless" overstated claims for refunds	$0.5	$1.3	$6.2	$12.2
Extend period before interest is suspended on tax returns	1.3	4.0	4.3	4.7
Increase penalty for failure to file partnership returns	—	0.9	1.7	1.8
Assess penalty for failure to file S corporation returns	—	0.6	1.0	1.4
Increase penalty for bad checks and money orders	—	0.4	1.0	1.0
Assess penalty if tax preparer understates taxpayer liability	—	—	0.3	0.6
Subtotals Penalty and Interest Modifications	($1.8)	($7.2)	($14.5)	($21.7)
Fee Modifications				
Modify fees for installment agreements	—	$4.0	$4.0	$4.0
Modify and assess fees for offers in compromise	—	0.4	0.4	0.4
Subtotals Fee Modifications	(—)	($4.4)	($4.4)	($4.4)
Federal Tax Conformity Issues				
Partially conform to federal backup withholding	—	$35.0	$35.0	$38.0
Conform to the IRS's "kiddie tax" rules for unearned income	—	—	15.0	11.0
Subtotals Federal Tax Conformity Issues	(—)	($35.0)	($50.0)	($49.0)
Totals	**$1.8**	**$80.6**	**$156.9**	**$178.1**

[a] Revenue estimates assume recommendations are effective January 1, 2010, and are net of implementation costs.
[b] Estimate reflects total revenues rather than net revenues.

Complying With Federal Withholding Requirement Would Increase State Revenues. Recent changes to federal law requires states to withhold 3 percent of the payments the state makes to businesses for contracts entered into on or after December 31, 2010. For example, under the new requirement the state would be required to withhold payments to a software developer for work performed. The State Controller's Office (SCO), which will be required to make changes to its systems to comply with this requirement, does not have a plan in place at this time to meet the federal deadline. The FTB estimates that implementation of the federal withholding requirement could result in a one-time accelerate of state General Fund revenues of $26 million in 2010-11 due to the earlier receipt of taxes owed. The costs to implement such a requirement are unknown at this time. We recommend the Legislature direct SCO to develop a plan and cost estimate for implementing the federal requirement. We note, however, that this federal requirement is being considered for repeal as part of the federal economic stimulus package.

Penalty and Interest Modifications Would Increase State Revenues

Tax laws generally impose penalties in order to encourage taxpayers to comply with their tax obligations and penalize taxpayers for late payments. While the state currently assesses some penalties and interest on noncompliance, we have identified many circumstances where penalties currently are not assessed or are inadequate to deter noncompliance.

Penalize Taxpayers Claiming Baseless and Overstated Tax Refunds. Taxpayers can claim a tax refund on their income tax if the tax they owe is less than the amount they paid during the tax year through withholding. Sometimes taxpayers overstate the refund due to them, and FTB estimates that in 2007 it received approximately 930 claims for refunds that were overstated. The FTB estimates that among these, 200 had no basis in law (called "baseless" overstated claims for refunds) valued at an estimated $60 million in tax refunds.

Assessing a penalty for baseless claims for refunds would provide an additional deterrent to taxpayers and would allow FTB to redirect staff from processing, auditing, and resolving refund disputes to other revenue-generating audit activities. If the Legislature were to direct FTB to mirror federal policy, the state would impose a penalty that would be equal to 20 percent of the disallowed portion for refund for which there is no reasonable legal basis. The FTB estimates one-time costs to implement this change would be $106,000 with $840,000 in on going costs. This recommendation is estimated to result in a net increase in General Fund revenues of $500,000 in 2008-09 and increasing to more than $12 million in annual net General Fund revenues by 2011-12.

Extend Period Before Interest Charges Are Suspended. Currently in an audit situation, FTB charges interest from the time the tax payment is due (usually April 15th) to the time the taxes are paid. However, if audit activities take more than 18 months, then it charges interest from when the audit is completed to when the taxes are paid. This restriction is estimated to have limited the accrual of $4.5 million in interest in 2007. The restriction can limit the application of interest to tax returns that have been selected by FTB for audit or special study. The state could extend this period to 36 months to mirror federal law. This would give FTB more time to complete audit-related activities before interest is suspended. Costs to implement the proposal would be minor and one time (approximately $62,000). This recommendation is estimated to produce $1.3 million in net General Fund revenues in 2008-09 and increasing to nearly $5 million in annual net General Fund revenues by 2011-12.

Increase Penalty for Failure to File Partnership Tax Returns. The FTB has identified more than 26,000 instances where a partner in a partnership failed to file a tax return in 2006. This represents an estimated $13 million in unreported taxes owed to the state. Currently, FTB assesses a $10 penalty per partner for each month or part of a month (for a maximum of five months) that the failure to file continues. By increasing the amount of the penalty to the federal penalty amount of $17 per partner, the adjusted penalty would act as an additional incentive for taxpayers to file the appropriate, completed tax returns on time. The costs to implement this proposal would be absorbable. This penalty increase is estimated to result in about $1 million in General Fund revenues in 2009-10, increasing to almost $2 million annually.

Assess Penalty on Shareholders Failing to File S-Corporation Returns. An S-corporation is similar to a partnership, in that the taxable income or loss of the corporation is captured on the tax returns of shareholders. An S-corporation is considered to have failed to file a timely return if it does not file the appropriate return on time, including approved extensions, or if it files a return that does not include all of the required information. The FTB estimates that there were approximately 16,000 failures to file S-corporation returns in 2007, representing an estimated $16 million in unreported taxes owed. While the FTB can levy a penalty on the S-corporation for failure to file, it does not have the authority to assess shareholders for failure to file. A shareholder penalty of $17 per partner, consistent with federal policy, would result in about $600,000 in net General Fund revenues in 2009-10, increasing to $1.4 million in annual net revenues by 2011-12. One-time costs to implement the proposal are estimated at $118,000.

Increase Penalties for Bad Checks and Money Orders. The FTB and BOE processed nearly 55,000 dishonored or bad checks or money orders with a face value of more than $100 million in 2007. Bad checks and money orders disrupt the tax collection process and delay the deposit of funds into the state's General Fund. The FTB assesses a $15 penalty on bad checks or money orders of less than $750, and if the dishonored check or money order exceeds $750, the penalty increases to 2 percent of the face value. The BOE does not charge a penalty on bad checks or money orders. The federal government assesses greater penalties for bad checks and money orders than the state. Specifically, if the amount of the bad check is between $25 and $1,250 the federal penalty is $25 and if the amount is $1,250 or more, the penalty is 2 percent of the face value of the bad check or money order.

Aligning the amount of California's penalty with federal penalties would act as a greater deterrent to taxpayers considering paying taxes owed with checks and money orders that have insufficient funds. In addition, increasing the penalty for bad checks and money orders would potentially result in General Fund revenues of $400,000 in 2009-10 and increase to nearly $1 million in additional annual General Fund revenues beginning in 2010-11.

Assess Penalty on Tax Return Preparers That Understate Taxpayer Liability. A tax return preparer is someone who prepares—in exchange for compensation—all or a substantial portion of a tax return or claim for refund. If the tax preparer does not appear to have used a reasonable interpretation of tax law when preparing the tax return, a tax preparer is considered to have understated a taxpayer's liability. In some cases, the understatement of the taxpayer's liability is considered intentional. The FTB estimates more than 700 tax preparers understated taxpayer liabilities in 2007, accounting for nearly $30 million in taxes owed to the state, but not paid.

The FTB has the authority to levy a penalty of $250 per return filed on tax preparers who understate tax liabilities. This penalty could be modified to be more consistent with federal penalties by increasing the penalty amount for understatements and employing a tiered penalty structure—making the penalty as high as the greater of $5,000 or 50 percent of the income from preparing the return when the understatement by the tax preparer was intentional. Costs to implement this change would be absorbable. This penalty increase is estimated to produce $300,000 in net General Fund revenues in 2010-11, increasing to $600,000 in annual net General Fund revenues in 2011-12.

Fee Modifications Would Increase State Revenues

Fees are used to cover the cost of providing a service. While the state currently assesses fees for some services related to increasing tax compliance, we have identified two circumstances where fees are not currently assessed or do not cover the cost of services provided.

Structure Fees for Installment Agreements to Reflect Processing Costs. The BOE does not charge a fee for installment agreements (IAs), which are agreements between the state and a taxpayer that allow the taxpayer to pay their delinquent tax debt over a specified period of time. The FTB and IRS, however, do charge fees for this service. The IRS charges $52 per agreement for electronic funds transfer (EFT) payment arrangements and $105 per agreement for paper check agreements. The FTB, in contrast, charges a flat fee of $20 per agreement, which does not cover the cost to provide the service or reflect the higher cost of processing non-EFT payments. The FTB has determined that a fee of $35 for EFT IAs and a fee of $63 for non-EFT IAs would cover the costs of installment agreements. We estimate that implementing a fee at BOE and increasing the fee at FTB would result in combined annual General Fund savings of approximately $4 million annually.

Modify Agreements to Settle Taxes Owed and Assess Fees. The FTB allows taxpayers under certain circumstances to enter into an agreement, also known as an offer in compromise (OIC), to settle taxpayer liabilities for less than the full amount owed. The BOE currently allows businesses that are no longer operational to enter into OICs, and the administration's 2009-10 budget proposes to allow BOE to enter into OICs with businesses that are still operational. The FTB's OIC process also requires the taxpayer to agree that if there is an unanticipated increase in income in the five-year period following execution of the OIC, the taxpayer is obligated to pay an additional percentage of that increased income to FTB to offset the forgiven portion of the OIC-retired tax debt. These are known as collateral agreements. The FTB reviews approximately 300 collateral agreements each year and over the past several years has collected an average of $500,000 in additional annual General Fund revenue as a result of these agreements.

We recommend the Legislature adopt the administration's proposal to expand use of OICs at BOE but also require BOE to enter into collateral agreements with open businesses. One of the advantages of the administration's OIC proposal is that it would allow BOE to offer taxpayers a payment plan, rather than requiring a lump sum payment. We recommend that the Legislature direct FTB to allow the use of a payment plan (not to exceed one year) for its OICs. Additionally, since OICs are a service provided to taxpayers, it would be appropriate to assess a fee. The Internal Revenue Service charges a flat fee of $150 per OIC. If FTB and BOE charged an application fee of $75 for each OIC, it would result in General Fund savings of approximately $400,000 annually.

Federal Tax Conformity

Many California tax provisions conform to changes the federal government makes to its tax system. Some of these changes occur without the state needing to change its tax laws, but in most cases legislation is needed to adopt the federal changes for California's purposes. We have identified two instances where it would make sense for the Legislature to pass legislation that would conform state tax rules to federal rules.

Implement Backup Withholding. Under federal law, if an employee or other payee who receives a taxable payment fails to supply his or her correct taxpayer identification number (TIN) to the employer, the payer is required to withhold 28 percent of the payment over and above the payee's normal withholding. This process is called backup withholding and is intended to compensate the government for potential lost revenues in cases where the inability to match a payment with a TIN makes enforcement problematic.

California does not require backup withholding. Assembly Bill 1848 (Ma), introduced in 2008, would have required the state to implement backup withholding. We recommend FTB conform to federal law (as would be required by AB 1848) in order to reduce the difference between taxes owed and taxes collected. The FTB estimates that approximately 155,000 California taxpayers would be subject to backup withholding. Costs to implement the proposal would be approximately $200,000 annually. If the state withheld 7 percent (this rate is consistent with FTB's withholding program for certain nonresident payments above a certain amount), FTB estimates that it would result in $35 million in net annual General Fund revenues in 2009-10, increasing to more than $38 million annually by 2011-12.

Conform to the Federal "Kiddie Tax." The federal kiddie tax requires unearned income in excess of $1,700 per year on assets owned by children to be taxed at the parents' tax rate. Federal law first applied this rule to the unearned income of children under 14 years of age. The age limit was later increased to 18. Subsequently in 2008, the limit can apply to the unearned income of dependent students until they reach age 24. California tax law does not fully conform to the federal kiddie tax and the state taxes only the unearned income of children under age 14 at their parents' rate. Costs to implement the proposal would be absorbable. The FTB estimates that conformity with the federal kiddie tax would generate approximately $15 million in net General Fund revenues in 2010-11.

Increase Tax Revenues Without Proposed IT System

New Information Technology Project Proposed. The budget proposes a $3.9 million increase in General Fund expenditures and the addition of 58 positions in 2009-10 (phased in over the year) for FTB to (1) resolve an existing backlog in business entity return processing and collections correspondence, (2) hire additional staff and consultants to document FTB's business processes, and (3) begin planning for the Enterprise to Data Revenue (EDR) project including issuing a request for proposals. The EDR project would take approximately seven years to implement and, once completed, would replace several older IT systems and streamline other existing systems. The FTB estimates the project will incur costs of $318 million during implementation (2008-09 through 2017-18) with annual costs thereafter estimated to be $14 million.

The EDR project proposes to increase revenues in a number of ways, including giving FTB staff access to all tax return data in an electronic form. The FTB asserts that having access to all of a taxpayer's submitted tax return information in an electronic form will allow FTB to better detect and collect taxes from those who are not paying the amount of taxes they owe. The project also includes the following improvements to FTB's systems that process personal income tax (PIT) and business entity tax returns:

- An underpayment modeling process that would be integrated with the Accounts Receivable Collections System and Taxpayer Information System.
- An enterprise data warehouse with data search and analysis tools.
- A taxpayer records folder that is accessible to the taxpayer and allows taxpayers and FTB staff to access the information.
- Re-engineering of existing business processes—including imaging of tax returns, data capture, fraud and underpayment detection, tax return validation, filing enforcement, and other audit processes—and integration of these enhanced business processes with FTB's existing tax systems.
- Improved business services at FTB such as address verification, issuance of notices, and a single internal password sign-on for its IT systems.

Postpone IT Project, but Approve Resources to Process Backlog. The proposed project would improve and streamline existing IT systems and business processes at FTB. Yet, it would come with a hefty price tag. Given the state's fiscal condition, we recommend postponement of the pre-procurement activities associated with the EDR project. We recommend, however, the Legislature approve 50 positions (phased in over 2009-10) to process the backlog in the business entity workload at a cost of approximately $2.5 million (General Fund). We recommend approval of these positions on a two-year limited-term basis, rather than as permanent staff, because the staff would process an existing backlog, rather than an increase in annual ongoing workload. These positions can be authorized independently of the IT project and are expected to accelerate $3.8 million in General Fund revenues in 2009-10, increasing to $14 million in accelerated General Fund revenues in 2010-11.

Direct FTB to Use Existing Tax Return Data to Increase Tax Revenues. Most PIT tax returns—68 percent or 10.4 million—and 16 percent (229,000) of business entity tax returns were filed electronically in 2007. However, the remainder of the tax returns were filed in a paper format. Only a portion of the information from paper-filed tax returns is scanned and keyed into FTB's systems in order to make it available to FTB staff electronically. Because the two processes—electronic filing and hard-copy paper filing—result in two different levels of access to taxpayer information, FTB has limited itself to using only a portion of all tax return data in its automated systems regardless of how the return is filed. Therefore, the rest of the information (including all of the tax schedules) that FTB receives from taxpayers is only used in FTB's manual—and more cumbersome—audit and collection processes.

In order to collect a greater amount of the taxes owed to the state, we recommend that the Legislature direct FTB to use all of the tax return information that it receives electronically in its automated audit and collection systems—rather than limiting itself to the same data that is available from paper tax returns. The FTB estimates that using the electronically filed data in this manner would increase General Fund revenues by approximately $20 million beginning in 2009-10 and require 17 additional permanent staff at a General Fund cost of $1.1 million. These staff would answer the telephones and handle the correspondence stemming from the increase in the number of audits, collections notices, and wage levies. In addition, expanding the use of automated tax audit processes should free up some staff resources at FTB. We believe that FTB could generate additional revenue by shifting staff resources currently used to conduct manual audits of the supplementary tax schedules and other information filed electronically to focus on paper returns. This would maintain a similar level of FTB focus on returns filed electronically and on paper.

California Emergency Management Agency

Governor's Emergency Response Initiative

The Governor's 2009-10 budget proposes to levy a 2.8 percent surcharge on insurance policy premiums statewide and to use the revenue to support emergency response activities at the Department of Forestry and Fire Protection (CalFire), the California Emergency Management Agency (CalEMA), and CMD. We discuss the spending proposals for CalEMA below and CMD later in this report.

Proposed Expenditures of Emergency Response Initiative Revenues

Consistent with the passage of Chapter 372, Statutes of 2008 (AB 38, Nava), the administration's budget reflects the merger of the Office of Emergency Services and the Office of Homeland Security into CalEMA. The Governor's budget proposes CalEMA expenditures of about $18 million ($16 million Emergency Response Fund, $2 million federal funds) beginning in 2009-10 to provide enhancements to the state's emergency response capabilities. Proposed expenditures from the Emergency Response Fund are shown in Figure 3 (see next page) and described below.

Wildland Firefighting Engine Fleet. The CalEMA currently owns 141 fire engines and related equipment used and housed by local firefighting agencies in wildfire emergencies.

A 2003 Governor's Blue Ribbon Commission recommended that the state's fleet be expanded to 272 fire engines in order to improve the state's ability to respond during wildfire emergencies. The budget proposes to purchase an additional 131 engines over five years for the CalEMA fleet, bringing the total number of state-owned engines to the recommended level. The cost for this proposal is about $13 million annually for five years, which includes six additional staff to manage the expanded fire engine fleet.

Addition of Staff at Regional Offices. The CalEMA's three regional offices coordinate the efforts of state and local resources during and after emergencies. The administration's budget requests a total of 19 additional positions in these offices to improve the state's response in an emergency. The cost for this proposal is about $3.2 million ($1.6 million federal funds and $1.6 million Emergency Response Fund) in the budget year.

Administration of the Emergency Response Fund. The Governor's budget requests ten positions to administer the Emergency Response Fund, collect revenues, and audit the use of the funds. The cost of this proposal is $650,000 in the budget year, increasing to $1.3 million in 2010-11 and beyond.

Law Enforcement Mutual Aid Support. There are seven mutual aid regions in the state. Five of the seven regions are overseen by a Law Enforcement Coordinator who serves as the contact person for local law enforcement when additional resources are needed to respond to an emergency. The Law Enforcement Coordinator also facilitates the deployment of state resources (for example, CHP officers) or resources from other areas to the afflicted area and trains local law enforcement on how to use the mutual aid network effectively. This proposal would provide the remaining two regions with Law Enforcement Coordinators. The proposal would also provide two Emergency Services Coordinators—one for the Mass Fatality Management Program and one for the Search and Rescue Mutual Aid Program—to improve planning and coordination in these programs. The cost of this proposal would be $560,000 in the budget year.

Study of Goods Deployment. The CalEMA reports that it has limited ability to rapidly (within the first 24 hours of an emergency) deploy emergency response goods to vulnerable populations in the event of an emergency or disaster event. The administration proposes to study how to store, manage, and transport critical goods immediately after an emergency or disaster event. The proposed cost to hire a contractor to com-

Figure 3

Emergency Response Initiative Proposals for the California Emergency Management Agency

(Emergency Response Fund, in Millions)

	2009-10	2010-11
Wildland firefighting engine fleet	$12.2	$12.9
Addition of staff at regional offices[a]	3.2	3.0
Administration of the Emergency Response Fund	0.7	1.3
Law enforcement mutual aid support	0.6	0.5
Study of goods deployment	0.5	0.5
Sacramento-San Joaquin Delta task force study	0.4	0.3
California State Warning Center	0.2	0.2
State Emergency Command Center	0.2	0.2
Totals	**$17.8**	**$18.9**

[a] About half of the funding is from federal funds.

plete the study is about $500,000 in 2009-10. (The length of time to complete the study and associated out-year costs are unknown at this time.)

Sacramento-San Joaquin Delta Task Force Study. Chapter 608, Statutes of 2008 (SB 27, Simitian), requires CalEMA to establish a Sacramento-San Joaquin Delta Multi-Hazard task force that will submit a report to the Governor and Legislature prior to January 1, 2011 on a proposed emergency preparedness and response strategy for the Delta region. The budget proposes to add two limited-term positions to establish the task force at a cost of $360,000 in the budget year.

California State Warning Center. The Legislature approved seven additional staff for the State Warning Center in 2006-07. However, the Legislature did not provide additional staff to supervise these employees. This proposal would add one additional supervisor for Warning Center staff. The cost of the proposal is $181,000 in the budget year.

State Emergency Command Center. The CalEMA currently contracts with CalFire for 3.5 fire captains to provide dispatching support in the State Emergency Command Center. State dispatching workload has increased due to the large number of fires throughout California. The administration proposes to reimburse CalFire for an additional full time fire captain at the State Emergency Command Center at a cost of $155,000 annually.

Recommend Against Funding Most of the Initiative's Proposals

Given the state's dire fiscal situation, we believe it is important for the Legislature to only authorize augmentations when there is a critical and immediate need. Therefore, we recommend not funding, or providing a lower level of funding, for many of the augmentations proposed for emergency response activities at CalEMA. Our funding recommendations are shown in Figure 4.

Reject Wildland Firefighting Engine Fleet. The additional fire engines requested would be used to mitigate *potential* deficiencies in fire fighting equipment, rather than addressing an immediate need. The existing mutual aid network—the system for sharing resources at the

Figure 4

LAO Recommendations for the Emergency Response Initiative Proposals For the California Emergency Management Agency

(In Millions)

	Administration's 2009-10 Budget	LAO Recommendation
Wildland firefighting engine fleet	$12.2	—
Addition of staff at regional offices	3.2	1.6
Administration of the Emergency Response Fund	0.7	—
Law enforcement mutual aid support	0.6	0.6
Study of goods deployment	0.5	—
Sacramento-San Joaquin Delta task force study	0.4	—
California State Warning Center	0.2	—
State Emergency Command Center	0.2	0.2
Totals	**$17.8**	**$2.3**

local, state, and national level in the event of an emergency—has allowed the state to successfully manage fire fighting resource needs in generally short timeframes when emergencies occur. Within the state, resources are often secured and relocated within a few hours. Out-of-state resources have also been generally secured in a few hours, with more distant resources available in two to five days. While expanding the state's ability to respond to wildfires may be an appropriate goal for the Legislature to pursue in the future, we recommend rejection of the proposal to approximately double CalEMA's fire engine fleet over the next five years given the persistence of the state's fiscal crisis.

Approve Some of the Regional Expansion Using Federal Funds. The requested resources would be used to mitigate potential deficiencies in services when multiple disasters occur simultaneously and in different regions of the state. This request does not address an immediate need in the emergency services being provided. The Legislature approved the use of federal funds for similar purposes in the form of grants to local governments in 2008-09 while rejecting the administration's request for state matching funds. Consistent with the prior funding approach, we recommend rejection of the requested Emergency Response Fund matching funds, while reauthorizing the federal funds as grants to local governments.

If Insurance Surcharge Is Approved, Fund Administrative Staff at Department of Insurance. We do not recommend approval of the insurance surcharge. We instead would fund the requested programmatic augmentations with General Fund and federal dollars. However, if the Legislature does approve the insurance surcharge, then it would be more appropriate to fund administration of the program through the Department of Insurance which collects existing insurance-related taxes.

Approve Law Enforcement Mutual Aid Support. Law enforcement coordinators play a unique role in managing the deployment of law enforcement resources in an emergency. The Mass Fatality Management and Search and Rescue Mutual Aid programs have experienced increased workloads. We therefore recommend approval of the four staff requested.

Reject Study of Goods Deployment. We recommend delaying funding for the study of how to best store, manage, and transport critical goods immediately after an emergency or disaster. While this may be a reasonable request, we cannot recommend it at this time given the state's fiscal condition.

Reject Sacramento-San Joaquin Delta Task Force Study. We recommend delaying implementation of Chapter 608, which would provide staff to establish a Sacramento-San Joaquin Delta Multi-Hazard task force. Again, while this is a reasonable proposal, we recommend that it not be approved at this time given the state's fiscal condition.

Reject California State Warning Center. We recommend rejection of funding for the supervisor at the Warning Center. It is not clear that the requested resources would be used to mitigate a critical deficiency in services provided by the state.

Approve State Emergency Command Center. We recommend the Legislature provide CalEMA with the funds to reimburse CalFire for the cost of one additional staff. This transfer would improve CalEMA's ability to track and manage deployed fire and rescue resources during a fire.

Recommend Rejection of Plans For New CalEMA Facility

New Facility Proposed Again. The budget proposes a $1.9 million increase in General Fund expenditures in 2009-10 for preliminary plans for the construction of a *replacement* facility for the Southern Region Emergency Operations Center at the Joint Forces Training Center in Los Alamitos. Additional project costs are estimated to be $30 million, including $2 million (General Fund) for the working drawings and $28 million in construction costs paid for with a future authorization of lease-revenue bonds. The project would construct (1) an approximately 30,000 square foot building that would serve as headquarters and an alternate State Operations Center and Warning Center (in addition to the main center in Sacramento), (2) a 120 foot high communications tower, (3) a 3,000 square foot warehouse, and (4) parking for 75 vehicles. According to CalEMA, the existing facility, which consists of two modular buildings totaling 7,200 square feet, has exceeded its useful life, requires increasing maintenance and ongoing repairs to remain operational, and does not meet basic facility standards such as seismic safety codes. Funding for the same purpose was requested as part of the *2008-09 Governor's Budget*, but rejected by the Legislature due to the state's fiscal situation.

Defer Project. While the existing facility will need replacement in the future, we recommend again deferring the project given the state's budget situation. This would reduce 2009-10 General Fund costs by $1.9 million.

Military Department

Aviation Firefighting Equipment Not Essential

As discussed earlier, the Governor's budget includes the Emergency Response Initiative, which is funded by revenues from a property insurance surcharge, and provides funds to several departments to support emergency response activities. The budget includes $2.2 million in expenditures for aviation firefighting equipment to improve the response capabilities of CMD. The expenditures for similar types of equipment would increase to $4.9 million in 2010-11.

Recommend Deleting Proposed Augmentation for Equipment. Given the state's dire fiscal situation, we believe it is important for the Legislature to only authorize augmentations that have the most critical and immediate need. While this equipment would likely improve the protection of life, property, and state resources, CMD currently owns some firefighting equipment. In addition, the state has access to firefighting equipment owned by the CalFire, as well as resources at the federal and local level. We therefore recommend rejecting the augmentation.

Expansion of Benefits Sought

The Governor's budget includes two proposals to create new programs that would enhance the benefits provided to members of the California National Guard (CNG)—tuition assistance and mental health services.

Tuition Assistance Program Not Justified. The CNG Education Benefit program would provide CNG members tuition assistance at California's Community Colleges (CCC), the University of California (UC), and California State University (CSU) at a cost of $1.8 million (General Fund) in 2009-10, growing to $3.7 million annually in subsequent years.

In recent years, the administration has made requests for tuition assistance funding, and the Legislature has rejected these proposals due to a variety of concerns about the administration of the program and its failure to target assistance to those with demonstrated financial need. The proposals and reasons for rejecting the requests are described in our *Analysis of the 2008-09 Budget Bill* (see page F-108). Given these concerns and the state's fiscal condition, we continue to recommend the Legislature not approve this augmentation.

Use Proposition 63 Funds for Mental Health Administrative Staff. The budget also proposes $1 million from the General Fund for eight staff to help ensure that mental health needs of members of the CMD and their families are being met. The staff would provide activities such as training and assessments to determine combat stress related needs.

We recommend the Legislature reject the proposal to fund these positions with General Fund dollars and instead direct the administration to explore the use of funds from Proposition 63, the Mental Health Services Act, passed in 2004. It appears that the staff proposed would engage in activities consistent with how Proposition 63 funding has been used in the past and the requirements of the act. Currently, over 14 different state departments use funds from Proposition 63 to fund administrative activities such as providing training and coordination of mental health services. For example, the Department of Veterans Affairs funded two staff at a cost of $496,000 in 2007-08 to support the development of a statewide veteran mental health referral network at the county level for all entities that may become access points for veterans and their families seeking mental health assistance. Funding for state administrative costs cannot exceed 5 percent of the total annual funds available from Proposition 63, but there is currently $24 million available to fund additional state administrative activities.

Secretary of State

Budget Does Not Fund the Cost of a 2009 Special Election

No Funds for Special Election Costs. As part of the 2008-09 budget agreement, the Legislature and Governor planned to use a 2009 special election to ask the state's voters (1) to authorize the borrowing of lottery funds to help balance the 2009-10 and 2010-11 budgets and (2) to strengthen existing balanced budget and reserve requirements. The administration's 2009-10 budget proposes two additional ballot measures that would redirect a portion of Proposition 10 and Proposition 63 funds to the state's general fund. The Governor seeks legislation to call the election on these measures for June 2009. While the revenues associated with the proposals are included in the administration's budget, the costs of administering a special election are not.

Costs Split Between State and Counties. State costs associated with special elections include activities performed by the Secretary of State (SOS)—such as the printing and mailing of voter information guides and voter registration cards to county elections officers and any overtime costs associated with election night reporting. The SOS estimates its costs for the 2009 special election will range from $6 million to $11 million (General Fund)—depending on the number of ballot measures included. In addition, the costs of some activities county election officers engage in for special elections (as well as regular elections) are reimbursed by the state under current mandate law, such as for absentee ballots. Costs counties incur for operating polling places and counting ballots also have been reimbursed in the past, although the state is not obligated to reimburse counties for these special election costs under current law. Potentially reimbursable county costs for activities associated with a 2009 special election are estimated to be in the range of $50 million. Actual costs, however, would depend on whether local governments were already scheduled to hold an election on the day of the state special election.

Funding Recommendation. We recommend that, once the actual costs of the election are known, the Legislature appropriate sufficient funds to the SOS for state costs associated with the special election. County costs for the election likely will not be known until part way through the 2009-10 fiscal year. Once this amount is known, the Legislature will need to decide whether to reimburse counties for nonmandated costs.

Employment Development Department

Prioritizing Workforce Investment Act Discretionary Funds

As we described in our *Analysis of the 2008-09 Budget Bill*, federal Workforce Investment Act (WIA) funds are available to states to provide employment and training services to unemployed and disadvantaged workers. Pursuant to federal law, 85 percent of the state's total WIA funds (an estimated $426.7 million in 2009-10) are allocated to local Workforce Investment Boards. The remaining 15 percent of WIA funds ($64 million in 2009-10) are available for state discretionary purposes such as administration, statewide initiatives, and competitive grants for employment and training programs.

In adopting the 2008-09 budget, the Legislature prioritized $9.5 million in WIA discretionary funds for parolee employment programs operated by CDCR. Absent WIA funding, the CDCR parolee employment programs would have been supported by state General Fund. Each WIA dollar prioritized to CDCR employment programs saved a General Fund dollar.

For 2009-10, the Governor proposes to reduce WIA funding for CDCR parolee employment programs to $2.3 million, at a General Fund cost of $7.2 million. Meanwhile, the Governor proposes to augment WIA funding for initiatives related to nursing education, veterans, economic stimulus, and critical shortage industries. *Given the state's fiscal condition, we recommend that the Legislature reprioritize the Governor's WIA discretionary spending plan to redirect $7.2 million to CDCR parolee employment programs.* This redirection would result in an equal amount of General Fund savings.

OTHER ISSUES

Restoring Solvency to the Unemployment Insurance Fund

Among other functions, the Employment Development Department (EDD) is responsible for administering the Unemployment Insurance (UI) program, which provides weekly payments to eligible workers who lose their jobs through no fault of their own. The UI fund is currently facing insolvency and, absent corrective action, would remain insolvent for the foreseeable future. During the November 2008 special session, the Governor introduced a proposal to restore solvency to the UI fund, which remains under consideration by the Legislature. Below, we provide an overview of the UI program, describe the Governor's proposal, comment on the proposal, and present an option to lessen its cost and financial impact on employers.

Background

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

Program Financing. Employers currently pay a combination of federal and state unemployment taxes on up to the first $7,000 in wages paid to each employee. The federal portion of the tax funds program administration, while the state portion funds benefit payments. Effectively, employers pay a federal tax rate of 0.8 percent as long as the state's UI program is in compliance with federal requirements. (If the state fails to comply, the federal administrative tax rate increases by 5.4 percent to a total of 6.2 percent.)

The actual state tax rate for each employer depends on two factors (1) the health of the UI fund and (2) the past utilization of the UI program by that employer's workers. With regard to the former, current law establishes a series of eight contribution rate schedules ranging from "AA" to "F+," with each rate schedule tied to various potential conditions of the UI fund. The rates can vary widely due to these factors. Schedule AA (with the minimum employer contribution rate of 0.1 percent) is used when the fund condition is most healthy. Schedule F+ (with a maximum contribution rate of 6.2 percent) is used when the fund condition is extremely weak (approaching or in deficit). When the economy is healthy and unemployment is low, the UI fund balance tends to increase and lower rate schedules, such as "A," are typically used to determine specific tax liabilities. When the economy softens and unemployment rises, the UI fund condition tends to deteriorate resulting in the use of higher tax rate schedules such as F+.

Within each rate schedule, the specific rate paid by each employer depends on the record of its employees in claiming UI benefits. This record is known as an "experience rating." Employers with a cycle of growth and contraction (such as the construction industry) pay at the higher end of each rate schedule, while employers with more steady employment trends (such as the retail trade) typically pay at the lower end of the schedules.

Employment Training Tax. In addition to the regular UI taxes, employers pay the Employment Training Tax (ETT), a 0.1 percent tax on the taxable wage base of $7,000 per employee. The ETT generally only applies to employers with positive UI reserve account balances, which means that the employers subject to this tax are those that have generally paid more in UI taxes than their former employees have received in UI benefits. The ETT provides funds to the Employment Training Panel (ETP), which awards training funds to employers in targeted industries to train their workers.

Statutory Benefit Level. State law establishes benefit levels to be paid to unemployed workers. The current maximum weekly benefit is $450. To qualify for benefits in California, a claimant must have generally earned at least $1,300 during one quarter of the most recent year.

Recent Benefit Increases. From 1992 through 2001, the maximum weekly benefit for UI was $230 a week for 26 weeks. Benefits were also limited to 39 percent of wages earned (referred to as wage replacement) in the base period, subject to the cap of $230. Chapter 409, Statutes of 2001 (SB 40, Alarcón), provided for a total increase in the maximum weekly benefit of $220 phased in over a four-year period, with the current maximum weekly benefit of $450 set in 2005. Chapter 409 also increased wage replacement from 39 percent to 45 percent effective January 2002, and to 50 percent effective January 2003. Although Chapter 409 nearly doubled the maximum UI weekly benefit from $230 to $450 over a phased-in period, the legislation did not raise the taxable wage base of $7,000 per worker, nor did it increase the tax rate schedules.

UI Fund Was Briefly Insolvent in 2004. In 2004, the EDD projected that the UI fund would experience a deficit and end the year with a shortfall of about $1.2 billion, despite the use of the highest tax schedule for employers. As a result, the state obtained its first UI loan from the federal government and borrowed money for April and May of 2004. This loan was completely repaid in May 2004. As we describe further below, federal loans are generally interest-free when repaid within a federal fiscal year (which begins each year on October 1). Therefore, the state was not obligated to pay any interest for this loan. As the economy subsequently improved, the UI fund was able to slowly build up reserves, although the fund did not become healthy enough to move employers off the F+ schedule. As we describe below, the recent decline in the economy has now dramatically changed the financial condition of the UI program.

UI Fund Condition Has Deteriorated

In May and October of each year, EDD reports to the Legislature on the status of the UI fund. The May 2008 report indicated that benefit payments would exceed total receipts during 2008 and 2009, and that the UI program was projected to have a shortfall of $257 million by the end of the 2009 calendar year. The EDD's October 2008 report, however, indicated that the UI fund's condition had deteriorated more quickly than anticipated due to the worsening economy. Specifically, EDD now projects a deficit as early as the first quarter of 2009, with a shortfall of $2.4 billion at the end of 2009, which will increase to $4.9 billion by the end of 2010.

We note that these deficit estimates assume unemployment rates of 6.6 percent, 6.7 percent, and 6.5 percent for 2008, 2009, and 2010, respectively. Our economic forecasts indicate higher average unemployment rates of 7.3 percent, 9.3 percent, and 9.5 percent for 2008, 2009, and 2010, respectively. In fact, by December 2008, the unemployment rate for California had already reached 9.3 percent. This means that the shortfalls in the UI program are likely be even greater than projected by EDD.

Federal Loan Means No Interruption In Benefit Payment

Federal Loan. Because of the UI fund's situation, EDD has already obtained a federal loan to cover the projected deficit in the first quarter of 2009. The federal loan will permit California to make payments to UI claimants without interruption. As requests for federal UI loans must be made on a quarterly basis, EDD will submit another loan request in March 2009 to cover the second quarter of 2009.

Repayment. As we noted above, federal loans that are repaid within a federal fiscal year are generally interest-free. However, federal loans that carry over from one federal fiscal year to the next will generally be assessed interest charges of 4.6 percent per year on the outstanding balance. The principal amount of any funds borrowed are repaid automatically to the federal government from the UI fund whenever the fund has a positive balance. However, interest charges may not be paid out of the fund and must be paid separately by states from another source.

Estimated Interest Costs. Absent corrective action, EDD estimates that the payment due to the federal government for interest for the borrowing period ending September 30, 2009, will be about $20.2 million. It further estimates that the payment for interest for the borrowing period ending September 30, 2010, will be approximately $133.5 million. If the Governor's proposal to correct the problem, which we describe further below, were adopted, interest costs for the period ending in September 2010 would decrease to an estimated $65.3 million. We note that the actual interest costs are likely to be significantly higher than estimated by EDD because they are based on the department's now-outdated projections of the unemployment rate.

Technically, the Governor proposes to use special funds to make the interest payment due to the federal government in September 2009. However, because any balances in these special funds are swept to the General Fund at the end of the state fiscal year, the interest payments are effectively paid from the General Fund. In addition, the administration proposes to add statutory language to the *2009-10 Budget Bill* to further tap these special fund sources in the event that the state's interest obligations to the federal government were to increase.

Potential Federal Consequences. The consequences of failure to pay the interest owed on the federal loan are so severe that the state has no practical alternative but to make the payment. This is because, as we noted earlier, California employers would face a 5.4 percent increase in their federal UI taxes, which would trigger the equivalent of a UI tax increase on employers of approximately $6 billion annually. In addition, the state would lose all UI administrative funds from the federal government, which currently amounts to about $360 million, until the interest has been paid. Absent these federal funds, UI administrative costs would most likely be backfilled by the General Fund.

The state also faces serious long-term consequences if it fails to remedy the underlying problem that resulted in this borrowing of funding for the UI system. Specifically, states must demonstrate progress toward restoring solvency to their UI funds within two years of receiving a federal loan, in order to retain the 0.8 percent rate and avoid a 5.4 percent federal UI tax increase, pursuant to federal law.

Governor's Proposal for Restoring Solvency

The Governor proposes several changes, commencing January 1, 2010, to both the revenue and benefit sides of the UI program to restore solvency to the UI fund. The Governor proposes no changes to the UI program for calendar year 2009 so as to avoid having a financial impact on employers and UI claimants during the recession. We note that although midyear changes in both tax rates and benefits are possible, each poses administrative difficulties. Therefore, the Governor's proposal to implement changes starting on January 1, 2010 is reasonable in that it minimizes the administrative impact on employers.

The key features of the Governor's proposals include:

- ***Increasing the taxable wage base*** from $7,000 to $10,500 per employee.
- ***Increasing the tax rates on each of the tax schedules,*** which would increase the maximum tax rate from 6.2 percent to 8.1 percent.
- ***Reducing the wage replacement rate*** from 50 percent to 45 percent.
- ***Increasing the minimum eligibility to qualify for benefits,*** which would increase the amount a claimant must generally earn in the highest wage quarter in a 12-month base period from $1,300 to $3,200.
- ***Increasing the penalty for individuals disqualified from UI benefits*** for quitting work without good cause or being terminated from work with good cause.

Impact of Governor's Proposal. The administration estimates that these proposed changes to the UI program would (1) increase employer contributions by approximately $4.1 billion in 2010 and (2) decrease benefit payments by about $300 million. Figure 5 outlines the major revenue and benefit policy changes and their estimated impacts on the UI fund, as well as on employers and workers.

Figure 5

Impact of the Governor's Proposed Changes to the UI Program

(Dollars in Millions)

Proposed Policy Change	Annual Fund Benefit	Examples of Estimated Employer Impact	Effect on Workers
Increasing the taxable wage base from $7,000 to $10,500 per employee	$2,700[a]	Median tax increase of $230 per employee per year	—
Increasing the tax rates on each tax schedule	1,400[a]	Median tax increase of $123 per employee per year	—
Reducing the wage replacement rate from 50 percent to 45 percent	200	—	396,000 would have decreased benefits
Increasing the minimum eligibility to qualify for benefits	92	—	29,700 would lose benefits

[a] These are Legislative Analyst Office estimates for purposes of illustrating the relative magnitude of the revenue changes. The revenue proposals are interactive and rejection of one reduces the fund benefit of the other.

UI = unemployment insurance.

LAO Analysis: Governor's Proposal Has Merit

Governor's Proposal Achieves Fund Solvency. We believe the Governor's proposal has merit in that, based on the available economic data, it brings the fund back into solvency. The state would still have to request a federal loan to cover benefit payments for part of 2010, but the UI fund is estimated to be solvent by the end of 2010, with a balance of about $122 million. In addition, the proposed changes are estimated to increase the fund balance to about $3.1 billion by the end of 2011. Therefore, even with a longer recession and higher unemployment rates, we believe the administration's proposed changes would likely restore solvency to the UI fund by late 2011.

We also find the administration's approach to be reasonable in that it brings employer contribution and employee benefit levels more into balance, both with each other and relative to other states' UI programs, as we elaborate below.

On the revenue side, California's maximum tax per employee is currently $434 per year, compared to an average of $995 for the nation as a whole. Under the Governor's proposal, the maximum tax charged per employee per year would increase to about $851, which would bring the tax closer to the average cost in other states.

With respect to benefits, California's maximum weekly benefit for UI claimants is currently $450, which is a little above the average maximum weekly UI benefit of $409 for all states. Under the Governor's proposal, the maximum weekly benefit amount would not change, although changes in the minimum eligibility requirement and wage replacement rate would eliminate or reduce benefits for some workers, as described in Figure 5. Approximately 29,700 workers would no longer be eligible for UI benefits, and an estimated 396,000 workers would see an average weekly benefit decrease of about $23.

Eliminate ETT as a Way to Lessen the Impact on Employers

Under the Governor's proposal, EDD estimates that employers will face a total tax increase ranging from $56 to $417 per employee per year based on the employer's experience rating. Because the ETT is also based on the taxable wage base, an increase in this base from $7,000 to $10,500 would increase the ETT that employers pay by $3.50 per employee per year, for a total of $10.50 per employee per year. This would result in an increase of about $30 million in revenue from the ETT, bringing the total annual ETT revenue to about $112 million.

As we previously mentioned, the majority of ETT revenue is appropriated to the ETP to provide training funds targeted to specific industries. The ETP consists of an eight-member board that meets monthly to review and approve training contracts for employers who wish to train their workers. Employers develop and submit applications for training projects, which ETP generally awards based on targeted priority industries. These priority industries include green technology, manufacturing, health care, construction, and logistics. The contract terms for awarded projects last 24 months, during which ETP staff monitor performance and incrementally fund training projects that meet established goals. Currently, an estimated 80 percent of businesses pay the ETT, yet relatively few are awarded training grants.

Employers would face a substantial increase in UI taxes under the Governor's proposal. *To partially offset this tax increase, we recommend* *that the Legislature eliminate the ETT.* Employers would collectively retain approximately $112 million that they would otherwise pay in ETT over the course of a year. During hard economic times, we believe it makes sense to partly offset the negative impact on employers of taking the unavoidable and necessary steps to restore solvency to the UI fund. We also question the premise of the ETP program. We believe that private businesses know their training needs better than any state entity could. Letting employers decide how much to spend for the training of their workforce is more efficient than having an appointed board make this decision for them.

State Retirement Costs May Skyrocket in Future Years

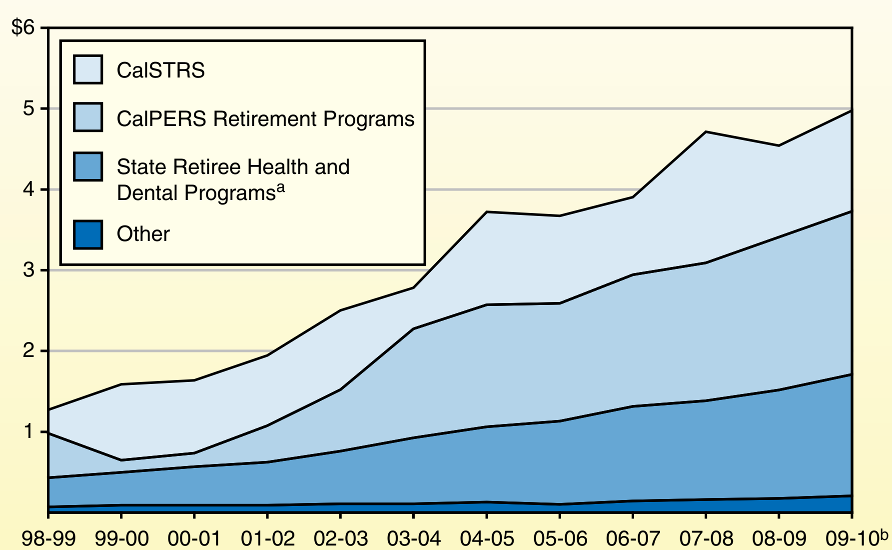
General Fund Retirement Costs Budgeted to Grow by 10 Percent in 2009-10

Retiree Health Is the Fastest-Growing Retirement Cost Category in the Budget. Figure 6 shows the budgeted General Fund contributions to various employee retirement programs—including California State Teachers' Retirement System (CalSTRS) pension benefits, CalPERS pension programs for state employees and judges, state retiree health and dental benefits, and other programs. As shown in Figure 6, General Fund payments to these programs are expected to total $5 billion in 2009-10—up 10 percent from 2008-09. (In addition to General Fund payments, special funds, and other state funds are expected to pay about $1.3 billion for CalPERS pension benefits in 2009-10.) The fastest-growing cost category (in terms of dollars) is that related to retiree health and dental benefits, which are administered through CalPERS and DPA, respectively. The General Fund line item for retiree health and dental costs is budgeted to grow by $139 million—up 12 percent from 2008-09—due to growth in premiums and enrollment. The "other" programs include a proposed appropriation of $20 million to UC's pension program, which comes after a nearly two-decade period when neither the state nor UC nor employees contributed to the plan. (We discuss the UC pension proposal in the *2009-10 Budget Analysis*

Figure 6

State Costs for Retirement Programs

General Fund (In Billions)



[a] Includes the budget item for these costs and estimated General Fund share of implicit subsidy for annuitant benefits that is paid along with employees' health premiums.

[b] Budgeted. Excludes consideration of possible savings under Governor's employee compensation proposals.

Series: Higher Education.) Payments to CalSTRS are budgeted to increase by $115 million—up 10 percent. About one-half of this increase results from a $57 million interest payment (the first of four annual payments) under a 2007 court order that required the state to make previously withheld contributions to the system.

Few Options for Savings in the Short Run… but Savings Options Exist in the Long Run. While the Legislature is contemplating cuts in many major program areas to address the state's budget deficit, Figure 6 shows that budgeted General Fund retirement costs increase by 10 percent in 2009-10. Unlike most other areas of the budget, the Legislature has very little control over these costs *in the short run*. Case law establishes that the bulk of these payments—principally those for CalPERS and CalSTRS pension programs—are enforceable contractually by retirement systems and their members. While the legal status of the state's contributions for retiree health and dental benefits has never been litigated, efforts to alter those benefits in order to reduce contributions substantially would likely result in litigation against the state. While these increased costs are difficult or impossible to avoid in the short run, the Legislature has several options to reduce future state costs in the long run, including:

- Altering future pension or retiree health benefits for state employees, teachers, and university employees (particularly for new hires).
- Spending more in the near term to address unfunded retiree health liabilities of the state and UC, which would help limit annual cost increases over the long term.

Grim Outlook for State's Pension Contributions in 2010-11 and Beyond

Pension Systems Worldwide Experienced Huge Losses in 2008. The large drop in the stock market during 2008—as well as broad-based difficulties in real estate and other segments of the investment markets—has strained pension systems worldwide, including CalPERS and CalSTRS. As of January 2009, the value of CalPERS' entire investment portfolio was under $180 billion, or about 25 percent below its value at the beginning of 2008-09. As of November 2008, the value of CalSTRS' investment portfolio also was down over 20 percent. While actuaries of both systems reported that their respective accrued liabilities were just under 90 percent funded as of their last valuations the pension systems' investment declines in 2008-09 probably will be so large that substantial state contribution increases cannot be avoided beginning in 2010-11. This is despite the fact that pension plans employ various techniques to avoid adjusting employer contribution rates upward or downward based on temporary fluctuations in the stock market. These contribution increases will be needed to begin addressing new unfunded liabilities that will emerge because of this year's investment losses.

Increased Costs in the Hundreds of Millions of Dollars Appear Likely for 2010-11. Actuaries at CalPERS have disclosed that, under existing system policies for setting state contribution rates, if the system's portfolio experiences a 20 percent loss in investment value during 2008-09, employer contribution rates may increase by about 2 percent to 5 percent of payroll. For the state, these increases would take effect beginning in 2010-11. While the precise state contribution increases will not be known until May 2010, we can make a rough estimate that a 20 percent or greater investment decline for CalPERS in 2008-09 could increase General Fund costs by hundreds of millions of dollars, with proportional increases for special funds. Under case law, the CalPERS Board of Administration has the exclusive power—relying on advice from its actuaries—to determine the state's pension contribution rates. By contrast, state contribution rates to CalSTRS are set by the Legislature in statute. This usually limits the year-over-year increase in regular state contributions to CalSTRS but the 2008-09 investment losses may be so large that state contributions to CalSTRS could rise sharply as well. This is because the Education Code (Sections 22955[b] and [c]) provide that the state is required to provide additional funding to CalSTRS if the actuarial value of its assets associated with benefit provisions in effect as of 1990 is less than the actuarial liability for those benefits. In recent years, the state has not had to contribute any funds for this purpose. A substantial drop in CalSTRS' asset value in 2008-09, however, could trigger this requirement beginning in 2010-11. While it is difficult to predict the cost impact for the General Fund, due to this provision, it could be in the hundreds of millions of dollars annually.

Office of the Chief Information Officer

Chapter 533, Statutes of 2006 (SB 834, Figueroa), established the Office of the Chief Information Officer (OCIO) and formally assigned duties to the state Chief Information Officer. Subsequent legislation expanded the responsibilities of OCIO to include the authority to (1) approve, suspend, and terminate IT projects; (2) establish and enforce state IT plans and policies; and (3) consult with agencies on programmatic needs and IT projects, among other tasks. In 2008-09, the Legislature provided about $7.1 million for support of the OCIO ($4.2 million General Fund, $2.9 million special fund and reimbursements), including funding for 34 positions.

Increased Staff

The Governor's 2009-10 budget requests an additional $6.4 million ($3.7 million General Fund), nearly doubling the OCIO budget, to fund 28 new permanent positions and external contracts for enterprise architecture and procurement consulting services. The requested positions would provide staff for newly created offices, including Legislative Affairs, Enterprise Architecture, Human Capital, Geospatial Services, and Project Management.

Insufficient Justification. Given the state's fiscal condition, we recommend that the Legislature generally not support augmentations for new program activities unless they can be clearly demonstrated to result in significant and timely offsetting savings. Most of the positions requested do not meet this criterion and we therefore recommend that they be rejected.

We do find, however, that the administration's request for four project managers to build a project management office has merit. The administration plans to loan these staff to various departments in order to manage ongoing IT projects. Hiring permanent staff to perform project management duties would alleviate, in part, the need to outsource these positions. It would also begin to build a pool of effective state project managers. Establishment of a project management office should lead to reduced risks and costs for IT projects.

Another budget proposal also warrants further consideration by the Legislature. The budget proposes three positions and about $400,000 for the Geospatial Services office, which would collect and maintain geographic information data, among other tasks. We note that the OCIO has received a $1.3 million federal grant from the Department of Homeland Security for geospatial information system development. Before dedicating General Fund monies to this office, the OCIO should advise the Legislature as to whether federal funds from this $1.3 million grant are available to support these positions in lieu of General Fund support.

We recommend approving $500,000 and 4 project management positions and rejecting the remaining request of 21 positions and $5.9 million. We withhold recommendation on the three positions for the Geospatial Services office pending receipt of additional information pertaining to the availability of federal funds to support these activities.

Education Data and Information Act of 2008

The budget requests $2 million (General Fund) and one position to fulfill activities required by Chapter 561, Statutes of 2008 (SB 1298, Simitian), known as the Education Data and Information Act of 2008. Chapter 561 requires activities by various state entities, including the Chancellor's Office of CCC, UC, CSU, the State Department of Education, LAO, and OCIO. The intent of Chapter 561 is to link data systems in the above education organizations and systems currently under development, such as the California Longitudinal Pupil Achievement Data System and the California Longitudinal Teacher Integrated Data Education System, to create an integrated statewide information system for education. Chapter 561 requires OCIO convene a workgroup and advisory committee and deliver a strategic plan to the Legislature by September 1, 2009 on the design of a linked education data system.

Implementation of Chapter 561. Our office has been supportive of efforts to improve the state's educational data systems. Currently, OCIO has no staff to absorb the additional activities mandated by Chapter 561. Given the state's fiscal condition, however, committing the requested General Fund resources for a strategic plan at this time may not be the Legislature's highest priority. (The Legislature's fiscal analyses at the time of Chapter 561's passage indicated much lower costs to implement the legislation.) We understand that the pending federal economic stimulus package may contain funds for states to implement education data systems, such as envisioned by Chapter 561. We therefore withhold recommendation on the administration's proposal pending more information on the availability of federal funds.

Reorganization Plan

On January 16, 2009, the Governor announced that he will submit a Governor's Reorganization Plan (GRP) to consolidate state IT resources under the OCIO. The plan will include moving the information security component of the Office of Information Security and Privacy Protection and the Department of Technology Services (both currently located in the State and Consumer Services Agency) and the Telecommunications Division of the Department of General Services (DGS) under the leadership of the OCIO. The Governor states that the GRP would result in increased coordination and more efficient use of IT resources.

Awaiting Further Details. At the time this analysis was prepared, the GRP had not been released. We will provide the Legislature with added information as details become available.

State Controller's 21st Century Project

Background

Human Resources Management System. In 2004, the SCO proposed an IT project that would replace existing statewide human resources management systems. Known as the 21st Century Project, the system will enable the state to improve management processes such as payroll, benefits, timekeeping, and position management. The existing systems are old and at risk of failure. In 2005, the Legislature approved the project with an estimated total cost of $130 million.

Two-Phase Procurement. Project staff decided to pursue a two-phase or "unbundled" procurement approach. This meant the state would be looking for two vendors and undertaking two procurements. The first vendor would supply the software package, and the second vendor (the primary vendor) would integrate the software to the state's business requirements.

Early Issues Delayed Project Development. During 2006 and 2007, SCO experienced multiple problems with the system integrator, the primary vendor hired to integrate the human resources software to the state's business needs. The vendor asserted that issues with the software package and with SCO were the primary reasons for delays. Eventually, SCO issued the vendor a breach of contract notice in October 2007 after multiple schedule delays. After discussions, the vendor and SCO reached a plan to address project failures and integration continued. These delays extended the schedule by two years and raised total costs to about $180 million.

Vendor Contract Terminated. After several months, the vendor again fell behind schedule, unable to complete project activities and provide deliverables on time. With the project schedule and development in jeopardy, DGS issued a default notice to the vendor on December 3, 2008. The notice stated that the vendor failed to (1) properly manage the project, (2) complete designs in a timely manner, and (3) make progress toward development. The vendor was given 30 days to respond and address the default but failed to do so. On January 6, 2009, SCO formally terminated the vendor from the contract and primary work on the 21st Century project stopped. Currently, the vendor is considering suing the state—arguing the state has terminated the contract for "convenience," rather than good cause.

Current Status

Project Expenditures. At the time this analysis was prepared, the SCO indicated that the state had spent about $70 million on project development, $25 million of which were primary vendor costs. The total amount expended constitutes nearly 40 percent of the estimated total cost for the project.

SCO Procurement Plans. Project staff are assessing the products completed by the vendor. Although not functional, some software configuration code had been written. Concurrently, based on the lessons learned from their experiences with the initial vendor, they are defining in more detail the business requirements and contractual obligations. Project staff expect to complete a request for proposal (RFP), reflecting these updated requirements, in the next few months and then enter into a roughly five-month procurement process. As part of the procurement process, vendors will be invited to assess the configuration work partially completed by the first vendor. Based on these assessments and the requirements as stated in the RFP, interested vendors would be asked to submit a proposal. Project staff will submit a preliminary project report including cost updates and project status by mid-February.

Budget Proposal. The Governor's proposal for 2009-10 requests 80 one-year limited-term positions and $9.6 million (General Fund) for the 21st Century Project. This request serves as a placeholder in the budget until procurement is underway and project needs and costs are more definitive. A spring Finance Letter will request additional funding reflecting the SCO procurement plan.

Options for Legislative Consideration

As noted above, the project has terminated its contract with the primary vendor and has expended about $70 million with few tangible deliverables to show for this. The Legislature has a difficult decision before it. Given the problems the project has faced and the money that has been expended thus far, the Legislature may feel that continuing the project would be "throwing good money after bad." However, the Legislature must also weigh the state's need for an updated human resources management system. Below, we discuss options that the Legislature could pursue, including halting the project, pursuing SCO's current plan, and restarting software integration from the beginning.

Halting the Project Not Advised. Halting the project would lead to immediate General Fund savings. However, the state's need for an updated and integrated human resources management system would be unmet. Additionally, several IT projects are depending on 21st Century implementation for aspects of their own development. For example, the Business Information System (BIS), currently being rolled out by CDCR, planned to interface with 21st Century to handle its human resource management needs. Due to SCO's delays, BIS now requires an interim solution and is planning around 21st Century for the short-term. Total project costs for BIS have increased. Other IT projects planning to interface with 21st Century could incur increased costs as well.

Concerns With SCO Approach. As described above, the SCO proposes to have a new vendor finish configuration of the software package partially completed by the prior vendor. We find this option holds potentially large risks for the project.

- There may not be enough vendors interested in or, more importantly, able to complete this project. A lack of vendors could lead to a situation where there are no competitive bids and could drive up the cost of the bid.

- Vendors may only be interested in submitting a bid if the state guarantees or holds harmless the new vendor for any bugs in the work already completed. Such a guarantee could also be costly and drive up state costs.

- Accountability issues could arise if the new vendor points to the original vendor as the cause of future failures in the system. This could create further delays and/or lead to litigation.

- California has no track record of a vendor successfully completing an IT project begun by another vendor. Though this does not mean it cannot be done successfully, the fact that it has not been done points to the difficulty of such an approach.

Clean Start on Software Configuration. Given the potential risks noted above, it may be more prudent to look for a new system integrator to begin configuration from the start. While the SCO approach could attract only a small number of qualified vendors, more vendors would likely be interested in a new integration contract when they would not need to rely on the partial work of the failed vendor. A bigger pool of vendors would lead to increased competition for the bid, ultimately giving the state more flexibility to choose a quality vendor and possibly bringing down the total vendor costs as well. Although this approach is less risky, it would probably cost more since the work of the initial vendor has to be redone.

LAO Approach: Require Project to Submit Cost-Benefit Analysis

Given that project staff cannot immediately assess the quality and value of the work completed by the first vendor, we recommend that the Legislature require the project to conduct a detailed cost-benefit analysis of two approaches: (1) hiring a vendor to complete configuration work of the first vendor or (2) starting configuration work from the beginning. This analysis should be part of a special project report available for discussion at budget hearings no later than May 1, 2009.

Please see the following write-up on FI$Cal regarding the possibility of merging 21st Century into FI$Cal.

Financial Information System For California (FI$Cal)

Background

Statewide Financial Management System. Initially contemplated in 2005 as a new budget system for the Department of Finance (DOF), by 2007, the administration concluded the state needed to replace its entire financial infrastructure. For 2007-08, the Governor proposed an IT project, the Financial Information System of California also known as FI$Cal, which would create a statewide financial system in all state departments. The new financial system would include budgeting, accounting, procurement, cash management, and financial management and reporting. The project was estimated to take eight years to develop at a total cost of $1.3 billion. The project would be based on the same type of software as the 21st Century Project. The administration proposed for it to be managed by a partnership of DOF, DGS, SCO, and the State Treasurer's Office. The Legislature appropriated about $7 million for the FI$Cal system for further planning in the 2007-08 budget and requested the administration deliver a series of reports to the Legislature addressing implementation issues.

Administration's Updated Proposal. In November 2007, the administration submitted a revised project report extending the schedule by two years and revising costs from $1.3 billion to $1.6 billion. The report proposed to finance most costs through bond financing, indicating debt service would begin in 2012-13 and be paid by departments based upon their share of use.

Legislative Concerns. In the *Analysis of the 2008-09 Budget Bill* (see page F-97), we expressed two major concerns regarding the administration's updated proposal: (1) risks around the project's scope and (2) the heavy reliance on bond financing. We recommended a two-phase implementation with a pause in between for legislative review. The initial phase would implement FI$Cal to a limited number of departments, followed by a pause when the administration would submit a status report to the Legislature. Only upon legislative approval would the project proceed to phase two and implement FI$Cal to the remaining state departments. We also proposed limiting borrowing to $250 million during the first few years of development.

The Legislature concurred and during 2008-09 spring hearings approved the development of FI$Cal in two phases. Both subcommittees authorized $40 million for support of FI$Cal for 2008-09 ($2 million General Fund and about $38 million from a General Fund loan). Trailer bill language provided the State Public Works Board authority to issue debt in the form of bonds (up to $277 million initially) to finance the early year costs of FI$Cal. Because the bond financing was expected to be in place by June 2009, the General Fund loan was scored as a cash-flow loan and not as a budgetary expenditure.

Change in Procurement Strategy. During 2008-09 spring budget hearings, project staff explained they would follow a bundled procurement approach, meaning they would seek one vendor to provide the financial software *and* configure it to the state's business requirements. However, in June, FI$Cal staff notified the Legislature of its decision to change to an unbundled procurement approach—seeking two separate vendors for the software package and for software integration through two separate procurements (as was done for the 21st Century project). The administration stated this approach would increase competition and enhance opportunities to secure the best software package and integration vendor.

Legislative Response. The budget conference committee expressed significant concerns about the project's decision to change procurement approaches after the Legislature had approved the original plans. Moreover, the administration could not justify its decision to change to an unbundled procurement and, when questioned, volunteered to return to the original bundled approach. As a result, the committee reduced funding to $2 million for 2008-09 and required the project to further review procurement approaches. During late summer budget negotiations, however, the Legislature restored funding to the FI$Cal project, including the authority to issue bonds, consistent with subcommittee approvals of a two-stage project.

Return to Bundled Approach. By mid-November, project staff decided to return to the original bundled procurement approach. Upon further review, they concluded conducting two procurements for an unbundled approach would take longer than they expected and place the project further behind schedule and increase costs significantly.

Current Status

Project Delays. Procurement approach issues and a late budget enactment have resulted in delays to the project. The RFP, originally slated for release in November 2008, will not be completed until June 2009. The project is experiencing hiring delays as well. At the time of this analysis, only $2.4 million of the $40 million budget for the current year has been expended, and it is likely the project will spend less than one-half of its authority by the end of the current year.

Project staff plan to update costs and schedule changes in the spring through a project report.

Bond Financing in Jeopardy. Given the state's current fiscal condition, there is significant concern over the state's ability to sell bonds. Even if the Legislature adopts a budget solution and national credit markets unfreeze, borrowing for state cash flow and infrastructure development could crowd out the ability to issue bonds for FI$Cal development—at least in the short term. In all likelihood, any General Fund loan would not be able to be repaid for the initial years.

Analyst's Assessment. We support a bundled procurement approach for the FI$Cal project. This approach limits the number of vendors that project staff must manage and keeps the vendor accountable for their work, rather than allowing them to blame another vendor for any system failure, as was partially the case with 21st Century project. Altogether, a bundled procurement approach appears to reduce project risk for FI$Cal development.

Despite the costs of development and initial project setbacks, we continue to recognize the state's needs to update its financial systems. We doubt that bonds can be issued in the current or budget year. Therefore, any project costs through 2009-10 should be scored as General Fund costs rather than a loan. The question is how best to proceed in this difficult fiscal environment.

Options for Legislative Consideration

Below, we provide possible options for the Legislature to consider in regards to the future of the FI$Cal project.

Option #1: Halt the Project for Now. The Legislature could halt FI$Cal development. The RFP could be shelved and project staff transferred to other projects. Any products the project has completed thus far, including the RFP, system requirements, and a schedule of accounts, could be used as groundwork to reestablish a FI$Cal system in the future. This option essentially means starting a new project during a more fiscally sound time.

Option #2: Delay Development. An alternative option is to delay FI$Cal development and the majority of initial costs until the state's fiscal condition begins to improve. The project staff could postpone release of the RFP and delay procurement, avoiding significant vendor costs in 2009-10. Some project staff could work on contingency plan development for the project, including funding options, while others could be loaned-out to other departments or projects temporarily.

Option #3: Phased Functionality. Financial functions could be implemented in a phased approach. Rather than integrating and rolling them all at once to departments, the FI$Cal system could be scaled back to initially include only core financial functions, such as accounting and budgeting. Additional functions could be added later. This option would lengthen the total time for full implementation of FI$Cal and increase overall project costs. However, it would decrease up-front development costs.

Option #4: Proceed With Governor's Approach. The project could proceed as planned and release the RFP in late June with the hope that the state's financial condition improves and bond financing becomes available.

LAO Approach: Delay and Reduce Initial Scope

We believe the risks of halting FI$Cal development outweigh the risks of continuing. Halting the project would essentially push development of some type of FI$Cal system into the future and result in significant duplication of effort. However, the state's current fiscal condition calls into question the feasibility of the Governor's approach. Instead, we recommend a combination of options two and three from above—delay and reduce the scope of FI$Cal.

Recommend Delaying and Reducing Project's Scope. Specifically, we recommend the Legislature delay the FI$Cal RFP release by six months until January 2010. This would push most vendor costs to 2010-11. Second, we recommend that the FI$Cal project report by May 1, 2009 on a revised plan that would reduce the initial scope of FI$Cal. This report should include the costs and benefits of delaying certain functionality, such as procurement.

Advantages of LAO Approach. There are several advantages to this approach. First, there are reduced initial development costs. Second, the initial reduction in scope could decrease the project's complexity and mitigate risks during development and implementation. Third, it minimizes disruptions to departments as they transition from the old legacy systems to the new system. Department staff would not have to learn new processes for all financial functions at the same time. On the other hand, we note that this approach would extend the length of the project and delay full implementation of all financial functions statewide. It would also result in greater total project costs.

Merging FI$Cal With 21st Century

As described earlier, we have advised the Legislature to require 21st Century project staff to provide, by May 1, 2009, a cost-benefit analysis which compares (1) hiring a vendor to complete the software integration started by the prior vendor and (2) hiring a vendor to start clean on software integration. We have also recommended a report on slowing FI$Cal's development during 2009-10. In assessing the two struggling projects at this critical juncture, we suggest the Legislature consider merging 21st Century staff with the FI$Cal project.

Potential Advantages of Merger. Merging the two projects would better leverage existing resources within both projects and potentially reduce some need for new staff in the budget year. The 21st Century staff have gained experience and knowledge in working with the vendor community and could apply both as they assist FI$Cal staff with their own procurement and project planning. Moreover, the 21st Century system will interface with FI$Cal and merging the two projects during the initial phases of FI$Cal development could assist in planning for this interface.

Other Major Issues. The merger approach would make more sense to the extent that the Legislature opts to move the two projects away from the administration's current plans. For instance, if the 21st Century project proceeds with the clean start approach, the potential merger makes more sense than if the project moves more quickly to hire a vendor to complete the integration started by the prior vendor. (In other words, we would not want a proposed merger to delay completion of the 21st Century project.) While the advantages of a merger could be significant, we note that combining staff from the two separate projects could create logistical issues and cause further project delays. For this reason, we believe further analysis of this merger is necessary.

Reports to Legislature. We have already recommended that, by May 1, 2009, the two projects report to the Legislature on their status and options for improving their completion. As part of these reports, both staffs, in consultation with the Chief Information Officer, should evaluate the advantages and disadvantages of a merger.

Indian Gaming Special Distribution Fund Deficit

Fund Has Several Functions Under Tribal-State Compacts and Current Law

The Indian Gambling Special Distribution Fund (SDF) is a state-controlled account available for appropriation by the Legislature only for gambling-related purposes under the state's compacts with various Indian tribes. The compacts do not prioritize the use of SDF funds for these purposes. Chapter 858, Statutes of 2003 (SB 621, Battin), however, specifies the funding priorities for the SDF in the following order:

- Covering annual funding shortfalls in the Indian Gaming Revenue Sharing Trust Fund (RSTF), which distributes grants of $1.1 million per year to tribes that have no casino or only a small casino (with fewer than 350 slot machines).
- Programs that address problem gambling.
- Regulatory programs of the California Gambling Control Commission and the Department of Justice concerning tribal casinos.
- Grants to local governments to address the effects of tribal casinos on local infrastructure and public services.

Compacts Provide That Tribes Should Be Consulted on Local Grants. The state's compacts with tribes provide that it is the "intent of the parties" that the state's casino tribes "be consulted" in identifying uses for the local grants. Chapter 858 formalizes this consultation process by establishing a seven-member committee in each county with a tribal casino. Chapter 754, Statutes of 2008 (AB 158, Torrico), addresses certain findings in a 2007 report by the Bureau of State Audits that were critical of the local grant process and helped secure the Governor's approval in the bill (following an earlier veto) of a $30 million appropriation from the SDF for these grants in 2008-09. Chapter 754 also extends for one year—to January 1, 2010—an existing sunset date on the statutory local grant process.

Three Counties Receive Nearly Two-Thirds of All SDF Local Grants. Three Southern California counties—Riverside, San Diego, and San Bernardino—are expected to receive two-thirds of all SDF local casino grant funding in 2008-09. As we discussed in our February 2007 report, *Questions and Answers: California Tribal Casinos* (see page 6), the majority of the state's casinos and around one-half of the slot machines were located in these counties as of 2006. In addition, all of the amended compacts ratified by the Legislature and tribes in 2007 to allow for major casino expansions—those for the Agua Caliente, Morongo, Pechanga, and San Manuel tribes—are for tribes located in Riverside and San Bernardino Counties.

SDF Revenues Have Plummeted, Producing a Structural Deficit That Could Affect the General Fund in the Future

SDF Operations Through 2007-08 Produced Large Surpluses and Fund Balances. As we described in our February 2007 report, tribes make payments into the SDF based on a percentage of revenue from machines operated as of September 1999. In the first years after the state's 1999 compacts with tribes took effect, these tribal payments were sufficient not only to support SDF appropriations, but also to build significant surpluses. As shown in Figure 7, this fund balance accumulated to $192 million at the end of 2007-08.

Several Tribes With Large Casinos Have Stopped Paying Into the SDF. The current administration has negotiated several expansion compacts with tribes operating large casinos. In general, the recent compacts negotiated by the Governor and ratified by the Legislature have (1) ended required tribal payments to the SDF, (2) increased required tribal payments to the RSTF, and (3) increased significantly the required tribal payments to the state's General Fund and/or a state transportation account. In 2007, the Legislature ratified amended compacts with the Agua Caliente, Morongo, Pechanga, and San Manuel tribes, which these tribal governments subsequently approved. These amended compacts, collectively, have generated significant increases in tribal payments to the General Fund, but have resulted in *huge* declines in the SDF's annual revenues. As shown in Figure 7, the SDF collected $152 million of revenues in 2006-07—the last full fiscal year before the four amended compacts went into effect. In 2007-08—when the new compacts went into effect part of the the way through the fiscal year—SDF revenues dropped to $109 million. For 2008-09 (the first full fiscal year under the new compacts), SDF

Figure 7

Special Distribution Fund (SDF) Has Structural Deficit

(In Millions)

	2006-07	2007-08	2008-09 (Projected)	2009-10 (Budgeted)
Tribal payments to SDF and other minor revenues	$147	$103	$48	$47
Interest income	5	7	3	3
Total Revenues	**$152**	**$109**	**$51**	**$50**
Transfer to Revenue Sharing Trust Fund[a]	$47	$46	$39	$39
Office of Problem Gambling costs	3	3	8	8
Department of Justice costs	13	15	15	16
California Gambling Control Commission costs	5	7	10	9
Transfer to Charity Bingo Mitigation Fund	—	—	5	—
Local assistance grants	30	—	30	—
Other costs	<1	<1	<1	<1
Total Expenditures	**$98**	**$71**	**$108**	**$73**
Annual Surplus/(Deficit)	54	38	-57	-23
Ending Fund Balance[a]	153	192	135	112

[a] For 2009-10, the transfer to the Revenue Sharing Trust Fund (RSTF) listed in this figure is at the same level projected for 2008-09. To ensure that the amount budgeted for the transfer is sufficient each year, the budget bill lists a higher amount ($50 million in the *2009-10 Budget Bill*, for example) and provides that any portion of that amount not required to be transferred to the RSTF remains in the SDF. Because of this adjustment, the 2009-10 ending fund balance listed above is $11 million higher than that listed in administration documents.

revenues are expected to drop to $51 million. Barring any future changes in the state's compacts, SDF revenues should stabilize at about the $50 million level for the foreseeable future. Because of this revenue decline, the SDF now has a large, unsustainable structural deficit that must be addressed by the Legislature within the next few years.

How Many Years Before the SDF's Fund Balance Is Wiped Out? As shown in Figure 7, the SDF is projected to run a $57 million deficit in 2008-09. In 2009-10, the Governor's budget—which does not include funding for any local grants—would result in the SDF having a $23 million annual deficit by our estimates. If the Legislature again were to appropriate $30 million from the SDF for local government grants in 2009-10, the deficit would grow by the same amount—to $53 million. Accordingly, the length of time before the SDF's fund balance is completely depleted depends largely on the level of local grant funding paid from the fund. If the SDF were to run $23 million deficits each fiscal year, the fund balance could be depleted by the end of 2014-15. If, on the other hand, the SDF were to run $53 million deficits each fiscal year, the fund balance probably would be depleted by the end of 2011-12.

Dwindling SDF Balances May Affect General Fund in Future Years. Due to recent compact amendments, General Fund costs are now intertwined with the SDF's fiscal health. The General Fund has an obligation under three recent compacts to cover the RSTF annual shortfall if the SDF cannot. Using the SDF to backfill the RSTF, therefore, relieves the General Fund of that obligation. Furthermore, if the SDF's fund balances are depleted, the General Fund will be pressured to cover other existing expenses of the SDF.

Reforming Local Grants Could Target Scarce SDF Resources Better And Protect the General Fund

Grant Allocation Law Has Outlived Its Usefulness, Given Major Changes in the SDF. As noted above, Chapter 858 establishes the process for distributing local grants from the SDF. Chapter 858 was developed when the SDF was flush with revenues, paid in large part by tribes that, under recently amended compacts, no longer pay into the fund. Moreover, under the recent compact amendments, these tribes have separate obligations in some circumstances (such as expanding their casinos) to enter into enforceable agreements with local jurisdictions to mitigate the effects of their casinos on nearby communities. Given these recent changes in the SDF, we recommend that the Legislature use the opportunity provided by the January 2010 expiration of the existing local grant law to institute significant changes to the local grant process.

Changes Should Focus on High-Priority Local Needs and Reconsider Existing County-by-County Allocations. In particular, we recommend that the Legislature emphasize two key priorities in reforming the SDF local grant process:

- Ensuring that only the highest-priority local infrastructure, problem gambling, and public safety needs resulting from casinos receive funding.
- Ensuring that any county receiving mitigation payments from a tribe with a recently amended compact does not also receive substantial SDF grant funding related to that tribe. (It is likely that this approach would reduce the percentage of annual SDF local grant funding distributed to Riverside County and San Bernardino County.)

Following these priorities would distribute limited local mitigation resources to the communities near casinos with high-priority projects that lack other mitigation resources. Under our approach, tribal governments would continue to be represented on local grant committees, thus fulfilling the state's compact requirements to consult with tribes in distributing local grants.

Lower Amount of Annual Grant Appropriations Justified Based on Recent Compacts. As described above, several recently amended compacts provide for tribes to make mitigation payments to local governments in specified instances. Given these provisions, we believe it is appropriate to reduce annual statewide grant appropriations from the SDF to $5 million or $10 million per year. Over time, under the recently amended compacts, more tribes can be expected to pay local governments directly—instead of through the state-controlled SDF—to address their casinos' impacts on community infrastructure and services. Moreover, providing only $5 million or $10 million of appropriations from the SDF for local grants in each of the next few years—as opposed to the 2008-09 appropriation of $30 million—could preserve the SDF's fund balance for a longer period of time. This would delay the point in time when the General Fund may have to cover a portion of existing SDF expenses. Further, this approach is consistent with Chapter 858's listing of the local grants as the lowest-priority use of SDF dollars.

Department of Consumer Affairs

Eliminations of Boards and Bureaus

The Department of Consumer Affairs (DCA) is responsible for protecting consumers by licensing various occupations and promoting good business practices and standards of professional conduct. The department includes 28 semiautonomous boards, commissions, and committees that regulate various professions. These boards are comprised of appointed consumer and industry representatives, and set policy for their respective industries or professions. In addition, the department regulates additional professions through 12 bureaus and programs, which are statutorily under the control of the director of the department, and subject to the policies set by administration.

Governor Proposes Elimination of Boards and Bureaus. As part of an effort to follow up on the work of the California Performance Review, the Governor proposes to get rid of four boards, four bureaus, and two committees within DCA through program consolidations and eliminations. Figure 8 shows the boards and bureaus that would be affected by the plan, and the expenditures proposed for each in 2009-10. (The numbers do not reflect anticipated costs or savings associated with the proposal.) As the figure shows, the organizations vary in size. In general, the Governor's proposal merges smaller entities into larger ones. In total, the proposed budget for these boards, bureaus, and committees represents 14 percent of the proposed 2009-10 spending level for the entire department.

While Details Lacking, Proposal Has Merit and Should Be Adopted. The administration has indicated that the overall goal of its proposal is to eliminate redundancy and reduce costs. We concur that opportunities for efficiencies and savings exist in DCA's regulatory programs. In the past, we have raised similar issues regarding the effectiveness of, or need for, several of the department's activities. As such, we think the Governor's proposal has merit and should be adopted.

In order to ensure that these changes are done in a cost-effective way, the Legislature would still require details from the administration regarding how the consolidation or elimination of the proposed boards and commissions would be implemented. At the time this analysis was prepared, we had not received the specifics on the proposal. For instance, it is not known how many and what types of positions would be eliminated as part of the proposed consolidations. Nonetheless, we think the proposal probably would result in program efficiencies, such as improved policy coordination among occupations in related fields and less duplication of work. The administration estimates that the proposal would save up to $3.5 million in special fund monies. We think the savings would probably be lower in 2009-10, potentially in the range of $1 million, but then increase in 2010-11 as full-year salary savings materialize. Under current law, any special fund balances of entities that were eliminated could be transferred to the General Fund.

The Governor's proposal relates to a relative few number of boards and commissions within DCA. We recommend that, at the time of budget hearings, the Legislature ask departmental representatives

Figure 8

Consumer Affairs Boards and Bureaus Affected by the Governor's Plan

(Dollars in Millions)

	Estimated 2008-09	Proposed[a] 2009-10
Proposed Consolidations		
California Board of Accountancy	$12.7	$12.9
Professional Fiduciaries Bureau	0.3	0.4
Subtotals	($13.0)	($13.3)
Board of Behavioral Science[b]	$6.4	$7.3
Board of Psychology	3.5	3.6
Psychiatric Technicians[c]	1.7	2.3
Subtotals	($11.5)	($13.1)
Speech-Language Pathology and Audiology Board	$0.4	$0.8
Hearing Aid Dispensers Bureau	0.8	1.0
Subtotals	($1.2)	($1.8)
Board of Registered Nursing	$24.1	$25.1
Vocational Nursing[c]	7.0	9.3
Subtotals	($31.1)	($34.4)
Board of Geologists and Geophysicists[d]	$1.4	$1.4
Proposed Eliminations		
Court Reporter's Board	$1.2	$1.2
Inspection and Maintenance Review Committee[e]	0.2	0.2
Landscape Architects Technical Committee[f]	1.1	1.2
Bureau of Naturopathic Medicine	0.1	0.1
Telephone Medical Services Bureau	0.2	0.2
Subtotals	($2.8)	($2.8)
Total Affected Boards and Bureaus	**$60.9**	**$66.8**
As Percent of DCA Budget	13.7%	14.2%

[a] Proposed consolidations and eliminations not reflected in January 10 budget.
[b] Would create a new Board of Mental Health.
[c] From the Board of Vocational Nursing and Psychiatric Technicians.
[d] Would be consolidated into the State Mining and Geology Board with the Department of Conservation.
[e] Now part of the Bureau of Automotive Repair.
[f] Now part of Architect's Board.

to discuss the efficiency and effectiveness of other boards, bureaus, and committees under the department's jurisdiction so that the Legislature may determine if additional entities should be reorganized or eliminated.

Department of Housing and Community Development

Suspension of Employee Housing Program

Employee Housing Act. The Employee Housing Act applies to two types of employee housing: (1) living quarters provided for five or more employees by their employer and (2) housing accommodations in rural areas for five or more agricultural workers that are not provided in connection with any work place. The act requires the owner to maintain these types of housing in compliance with certain minimum health and safety standards, developed by the Department of Housing and Community Development (HCD), and to obtain a permit from HCD prior to allowing the housing to be occupied. The HCD has primary enforcement authority unless a city or county assumes the enforcement responsibilities pursuant to the act. Currently, ten counties enforce the program (Kern, Merced, Monterey, Napa, Sacramento, San Joaquin, San Mateo, Santa Cruz, Stanislaus, and Tulare). Fresno recently discontinued its program, returning enforcement in its county back to the state.

HCD's Role in Enforcing the Act. The HCD's responsibilities under the act are to annually inspect proposed employee housing facilities, issue permits to conforming facilities, and reinspect non-conforming facilities; locate employee-housing facilities operating without permits and prosecute serious offenders; and monitor local government enforcement of the act. The department estimates that 765 facilities with approximately 19,600 beds for workers are subject to the act's requirements. It further estimates that 90 percent of the facilities are for the agricultural workforce, while 10 percent are for other industries (such as railroads and ski resorts). Currently, the fee structure for state permitted facilities is $35 for issuance of the Permit to Operate, plus $12 per bed or lot. The average fee is about $400 per facility.

Recent Funding History. In 2007-08, the program had a budgeted level of $1.1 million, which was funded with a combination of the fees charged to owners of the housing units ($231,000) and General Fund monies ($846,000). Last year, when the Governor proposed reducing the General Fund share of program support by $85,000, the Legislature adopted budget language allowing the department to increase fees to offset the reduction. However, the Governor subsequently vetoed the language as well as the remaining General Fund support ($761,000), leaving only $231,000 in fee reimbursements to fund program activities.

Governor's Proposal Has Some Potential Problems. The 2009-10 budget proposes to suspend the program for an unspecified period and grant local jurisdictions the discretionary authority to take over the state's Employee Housing Act duties. Accordingly, the budget proposes elimination of the fee authority for 2009-10.

We have several concerns with the proposal. While the proposal grants local jurisdictions the authority to enforce the act, it does not require them to do so. Thus, there is no assurance that there would be any level of enforcement while the state program is suspended. Since local governments currently have the option to provide these services and most choose not to do so, we have no reason to believe that a significant number of jurisdictions will rush to take on the enforcement responsibilities under the Governor's proposal. Moreover, under the Governor's proposal, there would be no state oversight of local jurisdictions to ensure that cities or counties that opt into enforcement actually meet their responsibilities.

Alternatives to Continue a Program. The Legislature has the following options to maintain an employee housing inspection program:

- ***Shift Inspection Responsibilities to Local Government.*** This option would, in effect, consolidate the employee housing program enforcement with local building, health, and safety inspections. This would likely be more efficient and effective since local enforcement authorities are geographically closer to the employee housing, have a greater ability to respond more rapidly to complaints, and have better knowledge of the area and the employee housing operations. Local governments already have the authority to raise fees to offset the costs for these kinds of housing enforcement activities, so a shift of these responsibilities would not constitute a reimbursable state mandate.

- ***Operate a Scaled-Down Inspection Program.*** The 2007-08 funding level was sufficient for the department to conduct about 75 percent of the annual inspection workload. If the current fee levels were maintained (and the base funding was not restored), HCD would conduct significantly fewer inspections than it now does. In light of this, it would be necessary to scale down the program so that the inspection workload more closely aligns with the funding available for the program. For example, the department could inspect facilities on a selective basis—focusing on those facilities with the worst conditions or the most complaints. In addition, HCD could issue some permits by mail, upon payment of fees, with self-certification for owners with a good record of compliance. Statutory changes would be needed to align the program requirements and funding in this manner.

- ***Increase Permit Fees.*** Providing additional funds through fee increases would enable HCD to maintain its current level of inspections. The department estimates that to operate at the 2007-08 funding level, it would be required to increase the average fees by about $1,900 annually or about 500 percent. However, as suggested above, the Legislature could decide to scale down the program and thus impose a lower level fee increase. The downside to raising fees is that it would increase the cost of providing employee housing and thus may reduce the amount of housing provided. The actual impact in this regard would depend in part on the level to which fees are raised.

Analyst's Recommendation. We recommend the enactment of legislation to shift the program's enforcement to local governments while maintaining their authority to collect fees to offset the cost of these activities. We believe local governments have the ability and expertise to perform the function. The state probably should maintain some minimal level of oversight of local enforcement to ensure that employee housing critical health and safety laws are being enforced.

Department of General Services

Energy Efficiency Upgrades

Proposed Spending for Energy Efficiency. The budget proposes a $5 million increase in Service Revolving Fund expenditures in 2009-10 to provide energy efficiency upgrades to lighting, heating, air conditioning, and ventilation systems at 12 state-owned facilities. Under the proposal, 80 percent of the funding requested would go to projects in Sacramento. The remainder would fund energy efficiency upgrades in state owned buildings located in Riverside, Stockton, San Francisco, and Redding. According to DGS, the proposed energy efficient upgrades will save the state money on its energy bills in the future. The department also suggests that approval of these projects would enable DGS to enter into agreements with California investor-owner utilities that would provide energy rebates to the state to offset the cost of future energy efficiency projects.

Withhold Recommendation. Despite the potential merits of improving the energy efficiency of state-owned buildings, committing the requested state resources at this time may not be the Legislature's highest priority given the state's fiscal condition. We understand that the pending federal economic stimulus package may contain funds for states to implement energy efficiency upgrades, such as envisioned by this proposal. We therefore withhold recommendation on the administration's proposal pending more information on the availability of federal funds.

Commission on State Mandates

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

Analysis of New Mandates

Chapter 1123, Statutes of 2002 (AB 3000, Committee on Budget), requires the LAO to review each mandate included in the commission's semiannual report of newly identified mandates. While the Legislature has not yet received this report, we understand that it will include the three noneducation mandates discussed below. (We will review education mandates separately.) We recommend the Legislature fund these mandates at the amounts proposed in the budget bill.

Handicapped and Disabled II—$12.1 Million. In 1976, Congress passed the Individuals with Disabilities Education Act to guarantee handicapped children the right to receive a free and appropriate public education. This includes special education and related services, such as mental health care necessary for a child to benefit from his or her education. Chapter 1747, Statutes of 1984 (AB 3632, W. Brown), created a state mandate by shifting to counties the responsibility for providing mental health services to special education pupils. A decade later, the Legislature (in Chapter 1128, Statutes of 1994 [AB 1892, Polanco], and Chapter 654, Statutes of 1996 [AB 2726, Woods]) expanded county special education duties to include providing psychotherapy, monitoring pupils' psychiatric medications, and participating in the educational planning process when pupils are placed in residential facilities. In 2005, the commission determined that these additional county activities constitute a reimbursable mandate. The budget proposes $12.1 million to reimburse counties for costs they incurred carrying out these responsibilities between 2001 and 2005. Ongoing funding for this mandate is budgeted separately under the Department of Mental Health.

Binding Arbitration—$210,000. Chapter 906, Statutes 2000 (SB 402, Burton), required local governments to engage in binding arbitration with peace officers and firefighters in the event collective bargaining negotiations reached an impasse. In April 2003, the California Supreme Court declared Chapter 906 unconstitutional because it delegated responsibility over local agency financial affairs to a private body. During the time before the legislation was overturned, one local government (the County of Napa) incurred costs to engage in binding arbitration. The budget includes $210,000 to reimburse the county for these mandated costs.

Firearm Hearing for Discharged Inpatients—$152,000. Chapter 9, Statutes of 1989 (AB 497, Connelly), prohibits individuals who have been placed in a county mental health facility from owning or possessing a firearm for five years after their release. Chapter 578, Statutes of 1999 (AB 1587, Scott), established a process whereby affected individuals may appeal this firearm prohibition through a civil hearing in Superior Court. The commission determined that some work by local district attorneys to participate in these civil hearings constitutes a state-reimbursable mandate. To simplify the process for reimbursing these minor administrative costs, the commission adopted a "reasonable reimbursement methodology" pursuant to Chapter 890, Statutes of 2004 (AB 2856, Laird). In 2007-08, the reimbursement amount is $81 per appeal. The budget includes $154,000 to reimburse local governments for their costs over the past decade.

Contact Information

Todd Bland	Director, Social Services	319-8353	Todd.Bland@lao.ca.gov
Farra Bracht	General Fund Overview	319-8355	Farra.Bracht@lao.ca.gov
Dana Curry	Director, Transportation, Business, and Housing	319-8320	Dana.Curry@lao.ca.gov
Jason Dickerson	Public Employment/Retirement/Gambling	319-8361	Jason.Dickerson@lao.ca.gov
Gregory Jolivette	Transportation/Business/Housing	319-8340	Greg.Jolivette@lao.ca.gov
Erika Li	Information Technology/Food Stamps	319-8306	Erika.Li@lao.ca.gov
Minsun Park	Child Welfare/Employment Programs	319-8342	Minsun.Park@lao.ca.gov
Crystal Taylor	Statewide Services	319-8357	Crystal.Taylor@lao.ca.gov
Marianne O'Malley	Local Government/Mandates	319-8315	Marianne.OMalley@lao.ca.gov

LAO Publications

The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

To request publications call (916) 445-4656. This report and others, as well as an E-mail subscription service, are available on the LAO's Internet site at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.