

STATE ADMINISTRATION





MAJOR ISSUES

Legislative Role in Oversight of Retirement Systems Is Unclear. Passage of Proposition 162 in November raises questions concerning the Legislature's oversight of the various state retirement systems. Implementing legislation is needed to clarify the extent to which public retirement systems still are subject to state laws and the State Constitution. (See page 12.)

Consolidation of State Tax Administration Agencies. A long-standing recommendation of the Legislative Analyst's Office has been to consolidate the existing tax administration functions of the Franchise Tax Board (FTB) and the Board of Equalization (BOE) into a new Department of Revenue. The Governor's Budget proposes that legislation be enacted to accomplish this reorganization. We recommend that the Legislature proceed to enact legislation establishing the Department of Revenue and direct the two agencies to begin planning for consolidation in 1993-94. (See page 14.)

Reform the Judges' Retirement Program. We recommend enactment of legislation to create a less costly retirement benefit plan for *new* judges that will be fully funded on an actuarially sound basis. We also recommend enactment of legislation that reduces the General Fund cost of the existing judges' retirement system. Possible changes could save \$15 million or more in 1993-94. (See page 21.)

Legislative Control of State PERS Contributions Needed. We recommend that the Legislature enact legislation to (1) rescind the continuous appropriations of the state's employer contributions to the Public Employee's Retirement System (PERS) and (2) require that the employer contribution amounts (\$765 million in the budget year) be reviewed and approved through the annual Budget Act. (See page 27.)

Redefining the State's Role in Teachers' Retirement. We recommend that the Legislature enact legislation to establish an alternative benefit plan for future entering members of the State Teachers' Retirement System (STRS) that is fully funded by member and school district contributions on an actuarially sound basis. This would result in future annual state savings in the hundreds of millions of dollars. (See page 40.)

Rethinking the Role of the Department of General Services (DGS). We outline two steps that the Legislature can take now to improve the department's delivery of services to state agencies: (1) introduce competition into the procurement of services and (2) authorize a business audit of the services provided by the DGS. (See page 70.)

Disaster-Related Costs Uncertain. The Office of Emergency Services (OES) has been unable to provide the information needed to track disaster-related costs on an ongoing basis for purposes of legislative oversight. We recommend that the office provide the Legislature with its cost estimates and establish an internal mechanism for tracking basic revenue and expenditure data. (See pages 76 to 78.)

Victims of Crime Program Funding Shortfalls. The program is expected to experience a shortfall of \$1.7 million in the current year and between \$18.4 million and \$20.1 million in the budget year. We recommend that the Board of Control report to the Legislature on the status of these funding shortfalls and the changes needed to address them. (See page 79.)



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OVERVIEW

Funding for state administration is proposed to increase in the budget year, primarily due to higher costs of retirement benefits and employee compensation. The Governor's Budget proposes slight decreases in the existing level of expenditures for local government aid and state operations.

The budget proposes expenditures for state administration of \$4.8 billion, which is 9.7 percent of expenditures from all state funds and 6.3 percent of General Fund expenditures proposed in the Governor's Budget for 1993-94. This level of expenditures is an increase of about \$586 million, or 14 percent, over estimated current-year expenditures.

Figure 1 shows that expenditures for state administration from all state funds have fluctuated moderately within the range of \$4.2 billion and \$4.9 billion during the eight-year period from 1986-87 through 1993-94. When adjusted for inflation, total spending for state administration has actually decreased at an average annual rate of 1.6 percent. The General Fund expenditures have declined at an average annual rate of 3.6 percent over the same period when adjusted for inflation.

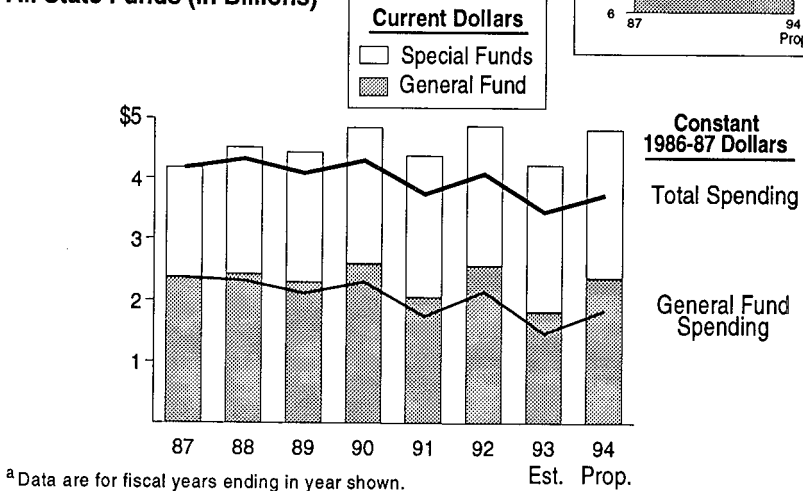
SPENDING BY MAJOR PROGRAMS

Figure 2 shows state expenditures for nine major state administration programs in 1991-92 and 1992-93, and as proposed for 1993-94.

Figure 1

State Administration Expenditures Current and Constant Dollars 1986-87 Through 1993-94^a

All State Funds (In Billions)



Local Government Aid. The largest program in this section is the shared revenues program, which distributes state-collected revenue to local government agencies. The \$48 million decrease in spending reflects a decrease of motor vehicle license fee revenue apportionments to cities and counties (\$43.5 million) and elimination of cigarette tax revenue apportionments to cities (\$4.5 million). This decline is attributable to the elimination of a one-time increase in subvention funding provided to local agencies in the current year. (This one-time subvention increase was offset by other one-time reductions in local funding.)

The state provides local property tax relief, both as subventions to local governments and as direct payments to eligible taxpayers, through seven tax relief programs. The two largest are the Homeowners' Property Tax Relief (Homeowners' Exemption) and Renters' Tax Relief (Renters' Credit) programs. The budget proposes a \$406 million net decrease in spending for tax relief programs from \$811 million in 1991-92 to \$405 million in the budget year. This is primarily due to the proposed elimination of the Renters' Tax Relief program in the 1992 and 1993 tax years. Elimination of this program is projected to result in savings of \$395 million in the current year and \$445 million in the budget year.

Figure 2**State Administration Budget Summary^{a,b}
1991-92 Through 1993-94****(Dollars in Millions)**

	Actual 1991-92	Estimated 1992-93	Proposed 1993-94	Change From 1992-93	
				Amount	Percent
Shared Revenues					
General Fund	\$2,140.4	\$2,183.0	\$2,135.0	-\$48.0	-2.2%
Special funds	0.2	0.3	0.3	—	—
Totals	\$2,140.6	\$2,183.3	\$2,135.3	-\$48.0	-2.2%
Tax Relief					
General Fund	\$811.0	\$432.4	\$405.3	-\$27.2	-6.3%
Contributions to Teachers' Retirement Fund					
General Fund	\$485.1	\$691.0	\$777.4	\$86.4	12.5%
Health Benefits for Annuitants					
General Fund	\$266.5	\$298.2	\$330.1	\$31.9	10.7%
Augmentation for Employee Compensation					
General Fund	—	\$6.0	\$134.0	\$128.0	— ^c
Special funds	—	2.0	52.0	50.0	— ^c
Totals	—	\$8.0	\$186.0	\$178.0	—^c
Payment of Interest on General Fund Loans					
General Fund	\$233.3	\$295.0	\$295.0	—	—
Board of Equalization					
General Fund	\$132.5	\$135.5	\$157.4	\$21.9	16.2%
Special funds	21.6	29.4	11.9	-17.5	-59.5
Totals	\$154.1	\$164.9	\$169.3	\$4.4	2.7%
Franchise Tax Board					
General Fund	\$213.4	\$211.5	\$204.9	-\$6.6	-3.1%
Special funds	0.5	1.2	0.4	-0.8	-63.9
Totals	\$213.9	\$212.7	\$205.3	-\$7.4	-3.5%
Department of General Services					
General Fund	\$6.0	\$6.3	\$6.3	—	—
Special funds	110.1	112.1	117.6	5.5	4.9%
Totals	\$116.1	\$118.4	\$124.0	\$5.6	4.7%

^a Excludes reimbursements, revolving funds, and other nongovernmental cost funds.^b Numbers may not add due to rounding.^c Not a meaningful figure.

The Governor's Budget also proposes to shift \$2.6 billion in property tax revenues from local governments to schools and community

colleges. We discuss this proposal in detail in *The 1993-94 Budget: Perspectives and Issues*.

Interest. To meet the General Fund's short-term cash needs, the state may borrow either internally, from the balances in other state funds, or externally by issuing short-term borrowing instruments such as revenue-anticipation notes. Payment of interest on General Fund loans is expected to remain the same in the budget year as in the current year—\$220 million from external sources and \$75 million from internal sources.

Retirement. We estimate that General Fund payments to the Public Employees' Retirement System (PERS) in 1993-94 will total \$340 million. The General Fund payments in the current year were entirely offset by the use of IDDA/EPDA funds in the PERS and deferral of one six-month payment to 1993-94. The estimated General Fund payment for the budget year has been adjusted to take into account another \$127 million offset from the remaining IDDA/EPDA funds. Expenditures for PERS are not shown in Figure 2. This is because these expenditures are included in individual departmental budgets throughout the Governor's Budget.

The State Teachers' Retirement System (STRS) receives contributions from teachers and their employers. However, these contributions are insufficient to provide for the cost of teachers' basic retirement benefits or the protection of retirees' purchasing power. The shortfalls are covered through annual transfers from the General Fund. Contributions to the Teachers' Retirement Fund (STRF) are proposed to increase by \$86.4 million, from \$691 million in the current year to \$777 million in the budget year. Of this increase, \$77.6 million is due to a formula increase to protect the purchasing power of retired teachers' benefits, and \$8.8 million is based on projected growth in teachers' payrolls.

In addition, the budget includes \$330 million from the General Fund to pay the health and dental premium cost for annuitants under various state supported retirement systems. This is \$31.9 million higher than current-year expenditures due to the increased number of annuitants.

Employee Compensation. The budget includes \$186 million (\$134 million from the General Fund) to fund a 5 percent pay increase for state employees. Of the General Fund amount, \$33.3 million is for the 5 percent pay increase negotiated for correctional employees (represented by the California Correctional Peace Officers Association) that takes effect June 30, 1993. The pay increase for all other state employees takes effect January 1, 1994.

Tax Agencies. The Board of Equalization collects state and local sales and use taxes and various business and excise taxes and fees; oversees the administration of the property tax; assesses public utility property; and hears appeals of decisions by the Franchise Tax Board. The budget proposes expenditures of \$169.3 million for the board in 1993-94. This is an increase of \$4.4 million over current-year expenditures primarily due to additional funding for audit and monitoring activities, and various salary and benefit changes.

The Franchise Tax Board is responsible for administering California's Personal Income Tax, Bank and Corporation Tax, Homeowners' and Renters' Assistance programs, and the Political Reform Act audit program. Funding for the board is proposed to decrease by \$7.4 million, from \$213 million in the current year to \$205 million in the budget year. This decrease reflects \$11 million in savings from the collection of new fees from delinquent taxpayers, \$1.6 million in savings due to implementation of a new computer system, and offsetting increases for additional tax compliance activities and salary and benefit changes.

General Services. The Department of General Services provides support services to state agencies. The budget proposes an increase for the department of \$5.6 million, from \$118 million in the current year to \$124 million in the budget year. Most of this change is due to purchases of equipment for the 9-1-1 and microwave programs, an increase in the state's motor vehicle insurance costs, and salary and benefit changes.

MAJOR BUDGET CHANGES

Figure 3 (see next page) shows the major budget changes resulting in an increase of \$586 million above current-year expenditures. The Governor's Budget generally proposes to decrease slightly existing levels of expenditures in the budget year for local government aid and state operations. However, the costs of employee compensation and retirement benefits are projected to increase significantly.

Figure 3

State Administration Proposed Major Changes for 1993-94 All State Funds

Local Government Aid	Requested:	\$2.5 billion	
	Decrease:	\$83.6 million	(-3.2%)



- \$48.0 million in shared revenues due to decreased apportionments to counties and cities
- \$27.2 million due to elimination of renters' tax credit
- \$8.3 million for continued phase-out of funding for the supplemental subventions program

Retirement Benefits	Requested:	\$1.2 billion	
	Increase:	\$124.8 million	(+11.9%)



- \$86.4 million for contributions to Teachers' Retirement Fund
- \$31.9 million for health and dental premiums for annuitants
- \$6.5 million for contributions to Judges' Retirement Fund

Employee Compensation	Requested:	\$186 million	
	Increase:	\$178 million	(—^a)



- \$178.0 million to fund a 5 percent pay increase for state employees (excludes \$52 million from nongovernmental cost funds)

State Operations	Requested:	\$1.0 billion	
	Decrease:	\$7.1 million	(-1.0%)



- \$3.2 million to upgrade 9-1-1 equipment
- \$2.3 million due to increased motor vehicle insurance costs



- \$24.5 million due to projected decrease in disaster assistance claims
- \$11 million due to imposition of new fees on delinquent taxpayers

^a Not a meaningful figure.



CROSSCUTTING ISSUES

THE STATE'S RETIREMENT SYSTEMS

The budget raises issues concerning legislative oversight of state retirement systems, as well as state costs associated with these systems.

Retirement-related expenditures account for a significant part of state spending for the budget year. The budget includes total state expenditures approaching \$1.7 billion, including almost \$1.3 billion from the General Fund, for various costs associated with public employee retirement. As summarized in Figure 4, the state makes employer contributions and/or various other payments to four public

Figure 4

State Costs for Retirement Systems^a 1993-94 (Projected)

(Dollars in Millions)

System	General Fund	All Funds
Public Employees' Retirement System	\$355	\$780
State Teachers' Retirement System	835	835
Judges' Retirement System	64	64
Legislators' Retirement System	1	1
Totals	\$1,255	\$1,680

^a Includes transfers to retirement trust funds for employer contributions, state mandates, retired judges' benefit payments, and other purposes. Does not include PERS and STRS administrative expenditures from trust funds. General Fund transfer to PERS net of offsets from surplus accounts in the trust fund.

retirement systems: the Public Employees' Retirement System (PERS), the State Teachers' Retirement System (STRS), the Judges' Retirement System, and the Legislators' Retirement System. The latter two systems are administered by the PERS for fees charged to the judges' and legislators' retirement funds and reimbursed by the General Fund.

Continued Legislative Role in Oversight of State Retirement Systems Unclear

Passage of Proposition 162 in November raises questions concerning the ability of the Legislature to perform an effective oversight role of the various state retirement systems.

In the November 1992 election, the voters approved Proposition 162—the California Pension Protection Act of 1992. This act may fundamentally alter relationships between retirement boards (at both state and local levels) and respective executive and legislative branches of government. In addition to the PERS and the STRS, over 100 retirement boards serving counties, cities, special districts, and the University of California are covered by the act. The act includes the following important effects:

- Grants to each public retirement board in the state "plenary" authority for investment of retirement trust monies and administration of retirement systems, notwithstanding any other provisions of law or the State Constitution to the contrary. The act permits the Legislature to continue to prohibit certain investments by boards "...where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board...."
 - Maintains the requirement that boards provide benefits to system members and their beneficiaries, minimize costs to governments for employer contributions, and provide for reasonable costs of administration, but specifies that the provision of benefits take precedence over the other two mandates.
 - Specifies that the Legislature cannot change terms and conditions of board membership (for boards with elected employee members), unless a majority of the persons registered to vote in the jurisdiction of the system approves the change. Thus, the Legislature cannot change the terms and conditions of membership for the PERS board (which includes elected employee members) without ratification of the changes by a majority of the registered voters in the state. The Legislature, by statute, can continue to change the terms and conditions of membership for
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the STRS board, without ratification by the voters, since the STRS board does not, at present, include elected employee members.

There are many issues related to implementation of this act that will be of concern to the Legislature. Key issues include (1) how the Legislature may carry out oversight of the budgets of the PERS and the STRS if those boards are free to spend funds without appropriations and (2) whether, or to what extent, the retirement boards are exempt from various statutory and constitutional provisions (including open meeting laws, fair political practices laws, civil service laws, and provisions for affirmative action). These issues have been brought to the surface by the 1993-94 budget proposed by the PERS, other actions taken or currently under consideration by the PERS, and a legal analysis of Proposition 162 prepared by the PERS General Counsel. We discuss these issues in more detail and make recommendations for legislative action in our analysis of the PERS budget (Item 1900), which follows this overview.

Other Issues Discussed in Analyses of Specific Retirement Systems

There are a number of other major issues specific to the following retirement systems that we discuss in our analyses of the individual systems.

Judges' Retirement System (Item 0390). In our analysis of the Judges' Retirement System, we discuss options available to the Legislature to place the system on an actuarially sound basis and reduce future General Fund subsidies.

Public Employees' Retirement System (Item 1900). In addition to implementation issues raised by Proposition 162, we review trends in PERS spending on external investment advisors and the Governor's proposal to transfer administration of state employee health benefit programs to the Department of Personnel Administration.

State Teachers' Retirement System (Item 1920). In our analysis of the STRS budget request, we discuss ways the Legislature can minimize General Fund contributions to the STRS in 1993-94 and beyond. These contributions are proposed in the budget at a total of approximately \$835 million.

TAX AGENCY CONSOLIDATION

The proposed creation of a Department of Revenue to carry out state tax administration activities represents a real opportunity to improve services and generate long-run cost savings. The Legislature should proceed with legislation to establish the Department of Revenue, and begin to work out the details involved in consolidating the tax administration activities of the two existing tax agencies.

A long-standing recommendation of the Legislative Analyst's Office has been to integrate the existing tax administration functions of the Franchise Tax Board (FTB) and the Board of Equalization (BOE) into a new Department of Revenue. The Governor's Budget proposes that legislation be enacted to accomplish this reorganization. The budget contains a proposal to accomplish this. Although the budget provides no details, the Department of Finance has informed us that the BOE would continue to perform its existing appellate function for Personal Income (PIT), Sales and Use (Sales), Bank and Corporation (B&C), and other tax controversies. The new Department of Revenue would assume responsibility for all other functions of the two agencies.

In our view, this proposal represents a real opportunity to achieve improved services and long-run savings despite the potential for increased costs in the short-run. As a result, we support the proposal to consolidate the tax administration functions of the FTB and the BOE into a new single agency.

Benefits of Consolidation

Consolidation Increases Accountability and Clarifies Management Authority

Probably the most important benefit from consolidation is the increased accountability for the operation of tax programs. By making a single entity responsible for tax administration, the Legislature and the Governor can expect that all of the state's tax administration resources would be directed to a unified mission.

The current system provides no clear-cut chain of command within the state's tax agencies. Because of the diffused authority structure, key civil service staff must serve independent board members and an increasing number of deputies. The executive branch provides additional policy direction to the agencies through the budgeting process. This organizational ambiguity can result in an inordinate

amount of staff time devoted to responding to directives from multiple authorities, and the failure to capture opportunities for innovation.

Consolidation Encourages Efficiency

The current system places artificial barriers in the way of efforts to most efficiently allocate and manage tax administration resources (including staff, computers, and facilities). The current system does not force the two agencies or the administration to make choices from an overall tax administration perspective. Each agency's budget requests are considered separately, and the agencies approach common problems in isolation of one another, often resulting in different solutions.

Consolidation would allow the state to manage its tax administration programs in a more efficient manner. Resources could be allocated to the particular tax program that provides the highest benefit to the state. In addition, the coordination of similar activities could result in more efficient use of existing resources. For example, collections activities require similar skills across types of taxes, and although taxpayer overlap is small, a coordinated approach could offer savings and, ultimately, productivity gains.

Consolidation May Enhance Public Perception Of State Tax Administration

We believe that an important benefit to consolidation is the potential to improve taxpayers' perception of tax administration in California. Consolidation, properly administered, could significantly enhance taxpayers' ability to conduct their affairs by (1) reducing the confusion over which agency is responsible for a particular tax issue, and (2) reducing correspondence with, or travel to, state tax agencies. Consolidation could also lead to coordinated taxpayer assistance programs that would provide taxpayers with comprehensive information about taxes in California. Changes of this kind may enhance the taxpayers' perceived view of service quality, even if convenience improvement is really only minimal.

Achieving Benefits Requires Up-Front Investment

The achievement of these and other benefits would require the Legislature to allocate funds to pay for certain costs associated with the consolidation effort. Initially, there would need to be a substantial amount of planning effort by management staff to implement a merger of the two agencies. This effort would not result in significant out-of-

pocket state expenditures, because it generally would divert some senior staff from other planning activities that would, at least temporarily, need to be subsumed within the larger planning effort.

There would be additional costs to (1) integrate the two agencies' computer systems, and (2) accommodate necessary physical plant changes. It is not possible to estimate these costs because they depend upon the pace of the merger. These additional costs, however, would be more than offset by long-term savings resulting from the efficiencies attributable to the integration.

What Should the Legislature Do?

Consolidation involves significant and complex issues that need to be comprehensively reviewed, and it could take some time to fully realize its benefits. However, there are at least two immediate actions the Legislature should take to start the integration process.

First, the Legislature should enact legislation creating a Department of Revenue, to take effect in January of 1994. In our view, an executive director should be appointed by the Governor and confirmed by the Legislature in order to achieve the most clear-cut chain of command and the best opportunity to achieve efficiencies. With this structure, the existing Board of Equalization would continue to perform its existing appellate function, but would no longer have tax administration responsibilities.

Second, the Legislature should direct the two existing agencies to develop a consolidation plan over the next year. The purpose of this plan would be to provide a specific course for integrating the operations of various functions within the agencies. The plan should identify specific goals for integrating activities (for example, data processing), and contain timeframes to reach these goals. The Legislature should instruct the two agencies to redirect existing planning funds to pay for the costs associated with developing the plan.



DEPARTMENTAL ISSUES

CONTRIBUTIONS TO THE JUDGES' RETIREMENT FUND (0390)

The Judges' Retirement Fund (JRF) provides benefits for those justice, municipal, superior, appellate and supreme court judges, and their survivors, who are members of the Judges' Retirement System (JRS). This system is administered by the Public Employees' Retirement System (PERS).

The primary revenues deposited in the fund come from the following sources:

- *Active members' contributions*, equal to 8 percent of members' salaries (about \$12 million in 1993-94).
- *Fees on civil suits* filed in municipal and superior courts (about \$3.8 million).
- *General Fund appropriations* (\$64.3 million in 1993-94), equivalent to 8 percent of the salaries of authorized judicial positions (\$11.8 million) *plus any amount necessary to cover JRS benefit payments each year* (an additional \$52.5 million in the budget year).

Members of the JRS earn retirement benefits equal to a percentage (up to 75 percent) of the *current* salary of the judicial office last held. The JRS will pay an estimated \$80 million in benefits to 1,315 annuitants in the budget year. This amount is \$10 million (13 percent) more than estimated payments in the current year.

Funding Problems of the JRS

System Continues to Be Underfunded

The payments made by current members of the Judges' Retirement System and their employers go directly to pay benefits to current retirees, providing nothing for the retirement of current judges. Moreover, these contributions are not even adequate to cover the benefit payments to current retirees, forcing the General Fund to make up the difference.

Active members of the JRS earn retirement benefits over the course of their judicial careers. The annual costs of ensuring that these benefits will be available upon retirement (without resorting to a General Fund subsidy) is called the normal cost. Because the normal cost for the JRS has been historically underfunded, there are insufficient assets in the JRF to pay benefits previously earned by active and retired members, thereby creating an "unfunded liability."

Based on the most recent (1991) actuarial valuation of the JRS, revenues totaling 36.43 percent of the payroll of active members are required in order to meet the normal cost. Current employer and employee contributions combined with other system revenues, however, provide less than 19 percent of payroll. The difference is the system's normal cost deficit. In 1993-94, this shortfall is expected to be approximately \$28 million.

Even if the normal cost were fully funded in the future, the system's current unfunded liability of the JRS would increase due to interest costs. The system's unfunded liability as of June 30, 1991 was \$1.2 billion, which was \$116 million, or 10 percent, higher than the prior year. The problem of a growing unfunded liability is compounded by not fully funding the system's normal costs. If contributions continue at current levels, the unfunded liability of the JRS will grow dramatically.

Figure 5 displays the normal cost requirements of the JRS compared to the employer and employee contributions and other system income over the period 1983-84 to 1993-94. The rapid growth in the unfunded liability is shown in the inset of Figure 5.

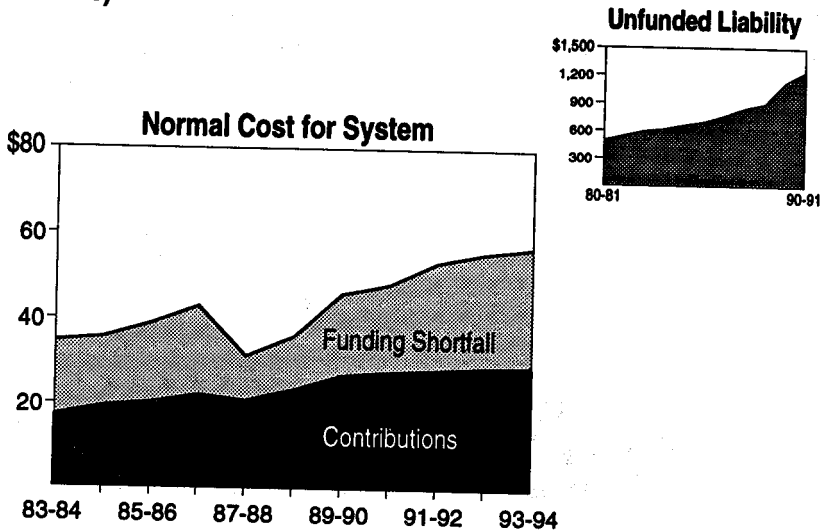
General Fund Subsidy Continues to Grow

In order to honor 1993-94 benefit payments to current retirees, the budget includes a subsidy of \$52.5 million from the General Fund—\$6.5 million above the current-year subsidy.

Figure 5

Judges' Retirement System Funding Shortfall

(In Millions)



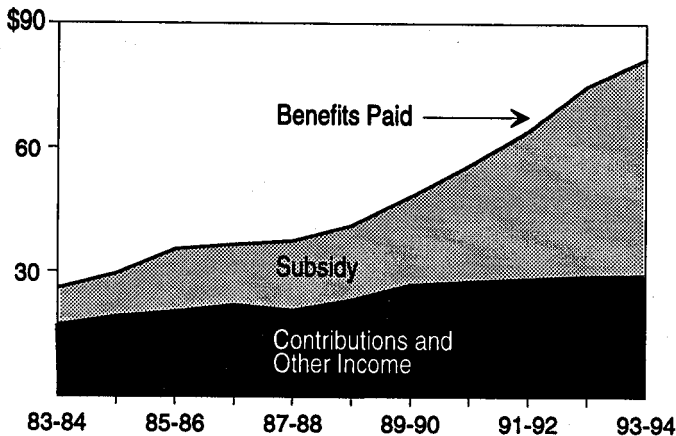
State law requires the Legislature to appropriate in the annual Budget Act enough monies to the JRF to pay all obligations of the system that become due in the ensuing fiscal year. Because no funds are accumulated in the JRF to pay for benefits as members retire, each year the Legislature is forced to provide increasing General Fund subsidies so that benefit payments can be made to retirees in that year. The 1993-94 subsidy is budgeted at \$52.5 million. This amount, when combined with employee/employer contributions and other system revenues, provides the \$80 million needed in 1993-94 to make these payments.

Figure 6 (see next page) shows the growth in the General Fund subsidy from 1983-84 to 1993-94. Unless the Legislature takes steps to address the fundamental problems of the JRS, the General Fund subsidy can be expected to continue growing at the current rate of between 15 to 30 percent per year. Under this scenario, the General Fund *subsidy* in 2001-02 would exceed \$200 million.

Figure 6

Judges' Retirement System Growth in Annual General Fund Subsidy 1983-84 Through 1993-94

(In Millions)



Addressing the JRS' Problems

Recent Legislative Activity

In 1992 the Legislature enacted two bills that would have made fundamental changes to judges' retirement, but the bills were vetoed by the Governor. Assembly Bill 1031 (Bentley) would have increased member contributions from 8 percent of salary to 11 percent. Senate Bill 1563 (McCorquodale) would have created a new, less costly, retirement plan for judges appointed or elected after the effective date of the bill (January 1, 1993). The Governor indicated in his veto messages that, although reform of judges' retirement is necessary, neither bill received the full review through policy and fiscal committees warranted by the issues involved. The Governor also expressed concern about maintaining the state's ability to attract superior talent into the judiciary. He invited the respective authors to re-introduce legislation in the 1993-94 session.

We believe reforms along the lines of the vetoed legislation are long overdue. The Judges' Retirement Fund needs to be put on a sound actuarial basis, with retirement benefits paid for as they accrue. This is

fiscally responsible because it does not conceal the full extent of the obligations created in providing government services, and does not confront future Legislatures with unfunded contractual obligations. In addition, the total costs for judges' services, including retirement costs, are paid by the generation of taxpayers benefiting from their services and are not shifted to future generations that do not benefit from them.

In order to place the fund on a sound footing, it will not be enough to make changes in the existing system for sitting and retired judges. It also will be essential to create a new, less costly, benefit plan for judges appointed in the future. Below, we discuss (1) possible changes in the existing system and (2) considerations for creating a system covering judges appointed in the future.

Changes to the Existing System

We recommend enactment of legislation that reduces the General Fund cost of the existing judges' retirement system, including legislation to increase member contributions (for a potential \$4.7 million General Fund savings in 1993-94). In order to capture these savings, we recommend reducing Item 0390-001-001 by \$350,000 and reducing Item 0390-101-001 by \$4,350,000. The Legislature also should consider options of (1) reducing benefits and (2) increasing the amount of court filing fees transferred to the JRF. Such additional steps could save the General Fund as much as \$10 million in 1993-94 and could produce major additional savings thereafter.

Increase the Judges' Retirement Contribution Rate. Since judges under the current benefit plan enjoy substantially more generous (and costly) retirement benefits than other public employees, there is a strong case to be made that they should contribute more than 8 percent of their salary toward retirement. The average service retirement benefit paid to retired judges exceeds \$66,000 annually. The annual costs of ensuring that these benefits will be available upon retirement (the normal cost) exceeds 36 percent of covered payroll. By contrast, the normal cost for teachers' retirement benefits is 17.5 percent of payroll and for most state employees is approximately 15 percent of payroll. Increasing the judges' contribution rate to 11 percent, as proposed in AB 1031 last year, is reasonable. We recommend reenactment of this proposal as urgency legislation. This would save the General Fund about \$4.7 million in 1993-94, with increasing annual savings thereafter. In recognition of the 1993-94 savings of such a step, we further recommend that the Legislature reduce Item 0390-001-001 by \$350,000 and reduce Item 0390-101-001 by \$4,350,000.

There are two other steps that could be taken to reduce the system's unfunded liability which the Legislature should seriously consider.

Reduce the Level of Benefits. The Legislature has the option, under existing law, to reduce benefits (at least marginally) for sitting judges who took office on or after January 1, 1980. Even marginal benefit reductions, applied to this group, could dramatically reduce the unfunded liability (currently \$1.2 billion and growing) of the existing judges' retirement plan and thereby produce significant savings to the General Fund in future years.

Increase Court Filing Fees and the Fund's Share of These Fees. Estimated annual revenues from fees on civil suits filed in municipal and superior courts for 1992-93 amount to roughly \$275 million. Of this amount, only \$3.8 million (equivalent to 2.4 percent of covered payroll) will be transferred to the JRF. At present, superior court fees are \$182 per filing, of which \$3 are transferred to the JRF. Municipal court fees are \$80, of which \$2 are transferred to the JRF. Although total filing fees were raised substantially in 1992, the fee amounts designated for the JRF have not increased since 1971. Therefore, revenues to the JRF from this source, as a percentage of covered payrolls, have steadily declined over time. If the fees designated for the JRF were to be adjusted for inflation since 1971, superior court fees for the JRF would increase to \$11, while municipal court fees for the JRF would increase to \$7. We estimate these increases would generate an additional \$10 million per year, offsetting annual General Fund transfers to the JRF by an equal amount.

The Legislature could raise the fees designated for the JRF either by (1) raising total fee levels (from \$182 to \$190 at superior courts and from \$80 to \$85 at municipal courts) or (2) redirecting a portion of the existing fee levels. Redirection within the existing fee totals, however, would reduce resources needed for trial court operations.

Create A New System for New Judges

We recommend enactment of legislation to create a less costly retirement benefit plan for new judges that will be fully funded on an actuarially sound basis.

Last year, SB 1534 created a new retirement benefit plan for judges elected or appointed after the effective date of the bill. Clearly, a new and less costly retirement plan is needed. In considering such legislation, however, the Legislature may wish to make specific provisions that depart from those of SB 1534. For example, rather than create a separate retirement plan for new judges, the Legislature could

specify that new judges become members of the PERS under one of the existing classifications for state employees. Such a step would dramatically reduce the future General Fund costs of judges' retirement.

As an alternative or as a supplemental benefit for new judges, the Legislature could create a defined *contribution* plan. Under this approach, each new judge would be free to choose an amount of salary to be deferred and invested until retirement (or separation from service). These amounts also could be matched on some basis by the state. The ultimate benefits would depend on the amounts so invested and the investment returns experienced.

The important point is, in providing for retirement benefits for new judges, the Legislature needs to create a system that will be fully funded on an actuarially sound basis. To accomplish this, a system that is less costly for the state is essential. Otherwise, the new system almost certainly would turn into the same type of pay-as-you-go system as the current system, with the same ever-growing unfunded liability and rapidly escalating General Fund costs. The state's costs, both near-term and long-run, can be kept at reasonable levels through one or more of the following:

- Reduced benefits,
- Increased member contributions,
- Increased use of defined contribution plans, and/or
- Increased use of alternative revenue sources (such as court filing fees).

Select Committee on Judicial Retirement

After the Governor vetoed AB 1031 and SB 1563, the Judicial Council established a select committee to develop recommendations to the Governor and Legislature regarding changes in judges' retirement provisions. Judicial Council staff expect the committee to complete its work in March 1993. We will advise the Legislature on the committee's findings after reviewing the its report.

PUBLIC EMPLOYEES' RETIREMENT SYSTEM (1900)

The Public Employees' Retirement System (PERS) administers retirement, health and related benefit programs that serve almost one million active and retired employees. The participants in these programs include state employees, most nonteaching school employees and employees of the 1,255 public agencies within California that have elected to contract for benefits available through the system. The proportion of members is approximately one-third each for state employees, nonteaching school employees and employees of other local agencies.

The system administers a number of alternative retirement plans through which the state and contracting agencies provide their employees with a variety of benefits. The costs of these benefits are paid from employer and employee contributions equal to specified percentages of each participating employee's salary. These contributions are designed to finance the long-term, actuarial cost of the various benefits provided.

The PERS health benefits program offers state and other public employees a number of basic and major medical plans, on a premium basis.

Overview of the PERS Budget

The Budget Bill does not include items of appropriation for the PERS (other than one item for health benefits administration) because the PERS contends that Proposition 162 grants it authority to spend funds without appropriations by the Legislature.

The Governor's Budget displays "for informational purposes only" expenditures totaling \$130.3 million for administration of the PERS in the budget year. Only \$5.8 million proposed from the Public Employees' Contingency Reserve Fund is specifically appropriated in the Budget Bill (Item 1900-001-950).

This unusual situation arises from an interpretation of Proposition 162 by the PERS Board of Administration. As discussed in the preceding crosscutting issues (*The State's Retirement Systems*), in the November election the voters approved Proposition 162—the California Pension Protection Act of 1992. Regarding Proposition 162 and the PERS, the budget includes the following statement:

"As the Board of Administration interprets Proposition 162 to give them sole and exclusive authority over the investment and administration of the System pursuant to the California Constitution, Article XVI, Section 17, no budget appropriation is required. The budget data presented is for informational purposes only and is not included in the Budget Bill as part of the appropriation process. This budget is included for informational display only and does not necessarily reflect the views of the Administration."

As mentioned above, however, the Budget Bill does include one item of appropriation for the PERS—\$5.8 million from the Public Employees' Contingency Reserve Fund for administration of the PERS Health Benefits program. This is included in the Budget Bill because, according to staff of the Department of Finance, the Administration disagrees with the PERS' position that the autonomy under Proposition 162 extends to the administration of nonretirement benefits.

PERS Implementation of Proposition 162

Proposition 162 grants public retirement boards, including the PERS, "plenary" authority for administration of retirement systems. Implementation of this change raises a variety of important issues.

Proposition 162 amended Article XVI, Section 17, of the state constitution to grant public retirement boards in the state "plenary" authority for administration of retirement systems. The PERS board interprets this to mean, among other things, that it is free to spend funds for administration of the system without appropriations by the Legislature. At this point the board of the State Teachers' Retirement System (STRS) has refrained from such an assertion. Thus, the Budget Bill includes an appropriation request for the STRS along the lines of requests in prior Budget Bills.

In addition to the budget autonomy claimed by the PERS, the General Counsel of the PERS has prepared a legal analysis of Proposition 162 (dated November 2, 1992) that asserts general independence for the PERS from state laws and the State Constitution. Among many points, the legal analysis contends the following:

- "...the Legislature cannot interfere with or prevent the Board from fully exercising its plenary authority to administer the System. For example, any attempt by the Legislature to repeal Government Code Section 20202 (providing for continuous appropriation of PERS funds) arguably would be an unconstitutional attempt to control the administration of PERS."
-

- The PERS is no longer required by the constitution to deposit its funds in the State Treasury (where expenditures are subject to appropriation and warrants drawn by the State Controller).
- Even if funds are retained in the State Treasury, the State Controller's authority to draw warrants for PERS funds is "ministerial" in nature only. The Controller would have no authority to "second-guess" any claims presented to him by the PERS.
- "A strong argument exists..." that the PERS no longer is subject to State Personnel Board or Department of Personnel Administration (DPA) authorities under the civil service system and may independently establish job classifications and pay scales.
- The PERS is not subject to DPA or any other authority in the setting of salaries and bonuses for executives and other staff.
- Gift limitation/prohibition under the Fair Political Practices Act should no longer prevent travel (including foreign travel) by members of the PERS board since Proposition 162 strengthens the argument that the PERS has sole discretion to determine when travel is reasonably necessary, and the sole power to authorize payment for this travel.

In most of the above areas the PERS has not yet taken specific actions. The important exception is its secession from the budget process, which we have noted already. Also, at its December 1992 meeting, the board made several revisions to the current-year PERS budget, including a revision that overturned a specific decision made by the Legislature in enacting the 1992 Budget Act. We discuss this board action in detail later in this analysis.

Finally, according to the legal analysis, it is uncertain whether the PERS is still subject to the following laws:

- Open Meeting and Public Records Acts.
 - Minority/Women Business Enterprise Participation Goals.
 - Fair Political Practices Act.
 - Civil Service Act.
-

Implementing Legislation Needed to Clarify PERS Role in State Government

We recommend the enactment of legislation defining terms contained in Proposition 162 in order to clarify the extent to which public retirement systems, including the PERS, still are subject to state laws and the state constitution.

As the above discussion indicates, Proposition 162 raises serious questions about the continued applicability of state laws and constitutional provisions to the PERS, and the basic relationship of the PERS to state government. In particular, uncertainties have arisen in important areas that were not addressed either in the text of the proposition nor in the public debate surrounding it. These areas include, but are not limited to, whether, or to what extent, public retirement systems remain governed by open meeting and public records acts, minority/women enterprise participation goals, the Fair Political Practices Act, and civil service acts. These issues need to be addressed by implementing legislation. This legislation should define terms of the proposition and clarify how administration of public retirement systems should proceed, in a manner consistent with the voters' intent in passing the proposition as well as consistent with the Legislature's constitutional responsibilities.

Legislature Should Continue an Oversight Role Through the Budget Process

We recommend that the Legislature enact legislation to (1) rescind the continuous appropriations of the state's employer contributions to the PERS and (2) require that the employer contribution amounts be reviewed and approved through the annual Budget Act.

The budget autonomy claimed by the PERS raises serious questions about the Legislature's future oversight role regarding budgets and operations of state retirement systems. These systems include not only the PERS, but the State Teachers' Retirement System, the Judges' Retirement System and the Legislators' Retirement System. The PERS may be correct in interpreting Proposition 162 as granting it authority to spend monies from its various trust funds without appropriations by the Legislature. The state's employer contributions to the PERS, however, are another matter. These contributions are appropriated from the General Fund and other state funds, and are still within the purview of the Legislature.

Under current law, employer contributions from the General Fund are continuously appropriated for transfer to the PERS pursuant to

Government Code Section 20751. These transfers, based on percentages of covered payrolls set by the PERS, are transferred semi-annually, six months in arrears, on July 1 and January 1 of each fiscal year. We estimate these General Fund transfers will be approximately \$340 million in 1993-94. The employer contributions from other state funds are continuously appropriated pursuant to Government Code Section 20752 for transfer on a quarterly basis. We estimate these transfers from other state funds will total about \$425 million, *for total employer contributions from the state of \$765 million in the budget year.*

There is no programmatic need for the employer contributions to be continuously appropriated. More importantly, the Legislature has an interest in reviewing these transfers each year since the contribution amounts are affected by (1) the level of PERS administrative expenditures (which now may be beyond the Legislature's *direct* control because of Proposition 162) and (2) actuarial assumptions set by the PERS. By appropriating funds for employer contributions through the annual Budget Act and requesting the PERS to report at annual budget hearings on the basis for the contribution amounts, the Legislature could continue an oversight role regarding PERS operations. We believe continued oversight is important for the interests of the Legislature and the public given the magnitude of annual state spending affected by the PERS. Moreover, legislative oversight is especially needed given the independence in other budget matters that the PERS has received from Proposition 162.

Accordingly, we recommend that the Legislature enact legislation to (1) rescind the continuous appropriations of the state's employer contributions and (2) require that the employer contribution amounts be reviewed and approved through the annual Budget Act.

Pension Abuse Audits: PERS Action Goes Against Expressed Intent of Legislature

We recommend that the PERS report prior to budget hearings on the basis for its reversal of the Legislature's direction in the 1992 Budget Act to bill public agencies for the costs of audits of those agencies.

In the 1992 Budget Act the Legislature approved \$1,803,000 from reimbursements to the Public Employees' Retirement Fund (PERF) for audits of public agencies that contract with the PERS for administration/provision of employee retirement benefits. The Legislature authorized these funds to investigate problems of noncompliance with state retirement laws, including pension abuses such as "spiking" (deliberate over-reporting of individuals' compensation in order to inflate retirement benefit payments). Selection of agencies to be audited

was to be done on the basis of information indicating potential compliance problems, rather than on a random basis. Accordingly, through Budget Act language (Item 1900-001-830) the Legislature specified that audited agencies reimburse the PERF for the full costs of audits.

At its December 1992 meeting the PERS board made several unilateral revisions to the current-year PERS budget, claiming new authority from Proposition 162. Among these revisions, the board appropriated the \$1.8 million directly from the PERF for the audit costs that the Legislature had expressly required be reimbursed by the audited agencies. The fiscal effect of this action is to spread the costs of the audits among *all* public entities in the PERS, *including the state*. (The General Fund ultimately would bear about \$450,000 of the cost since roughly 25 cents of every dollar spent by the PERS is reimbursed to the PERF by the General Fund through employer contributions.) The jurisdictional effect of the action is to directly contravene a specific action of the Legislature.

In view of the above, we recommend that the PERS report to the fiscal committees prior to budget hearings on the basis for the reversal of the Legislature's direction that audited agencies bear the full cost of these audits.

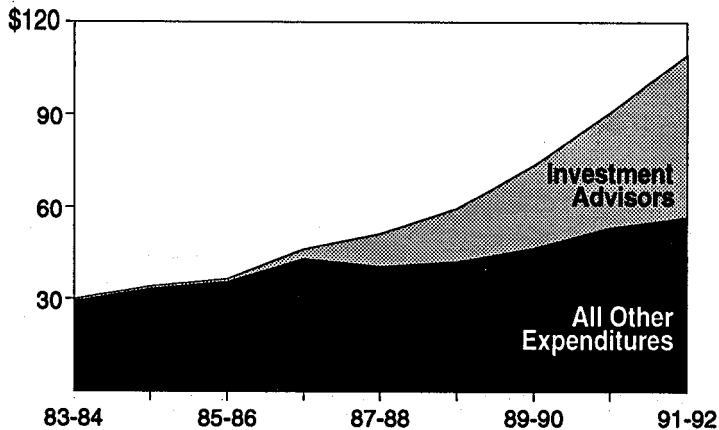
Spending on Outside Investment Advisors

The PERS' spending for outside investment advisors in 1993-94 is estimated at \$56 million—almost equal to PERS' spending on all other administrative costs (\$62 million). We recommend that the PERS report to the fiscal committees prior to budget hearings on its spending on outside investment advisors, including steps the PERS will take to ensure that in the future these expenditures are cost/beneficial, especially in comparison with in-house advisors.

Background

Chapter 1431, Statutes of 1982, stated legislative intent that the PERS secure investment advisors with the expertise necessary for the investment of the retirement fund portfolio. The act authorized the PERS to retain "not less than two separate individual investment advisers" and provided a continuous appropriation, without regard to fiscal year, for that purpose.

Figure 7 shows historical trends for PERS spending on investment advisors and on all other administrative purposes. It indicates that spending on investment advisors grew dramatically during the nine-year period 1983-84 through 1991-92. In 1983-84 the PERS spent \$779,000 for investment advisors under the continuous appropriation authority granted by Ch 1431/82. This amount was 2.6 percent of total administrative expenditures (\$30 million) by the PERS that year. By 1988-89 investment advisor spending had become a major part (29 percent) of administrative expenditures. From that significant base, however, spending continued to grow, tripling over the next four years. By 1991-92 spending on outside investment advisors (\$53 million) nearly equaled spending for all other aspects of PERS operations (\$57 million).

Figure 7**Public Employees' Retirement System
Administrative Expenditures
1983-84 Through 1991-92****(In Millions)**

It should be noted that the \$57 million for other administrative expenditures in 1991-92 included \$6 million for PERS' in-house investment office. That office has general responsibility for PERS investments, directly managing major portions of the portfolio and retaining responsibility for all aspects of portfolio management not delegated to the outside investment advisors.

Prior to 1993-94, spending on state operations for the PERS did not include expenditures on external advisors. For the first time, the 1993-94 Governor's Budget appropriately includes investment advisor spending as part of state operations. The incomplete display in past budget documents, combined with the fact that expenditures for investment advisors were continuously appropriated under the Government Code, meant that:

- The dramatic growth in spending on investment advisors proceeded without the Legislature's review; and
- The consequent rapid growth in *total* administrative spending by the PERS was masked by the more moderate growth rates presented in the budget documents.

Based on the past budget displays, PERS administrative costs rose at an apparent pace of 8.7 percent per year (average) from 1983-84 to 1991-92. Based on a full accounting, including investment advisor costs, administrative costs actually increased by an average *18 percent* per year during the period.

Increased PERS Spending Translates Into Higher General Fund Costs

The recent passage of Proposition 162 appears to take away the Legislature's authority to approve or disapprove proposed levels of PERS administrative spending. However, this record of administrative expenditures, as well as PERS spending plans for the future, remain a legitimate concern of the Legislature. This is primarily because every additional dollar of PERS administrative spending ultimately is paid by the state and public agencies that contract with the PERS through adjustments in employer contribution rates. Based on the state's share of employer contributions, the state reimburses roughly 50 cents of each additional dollar of PERS spending, with the General Fund paying roughly 25 cents of each dollar.

Increased Spending on Investment Advisors Has Not Clearly Resulted in Higher Returns

What appears on the surface to be a run-away spending situation might be justified if the PERS could demonstrate that the significant expenditures for investment advisors were resulting in higher returns on investments than reasonably could have been achieved without such spending. The record, however, does not demonstrate this case. For example, for the 12 months ending September 30, 1992, PERS total

investments gained 9.5 percent in value. This is below the median 10.67 percent gain for a comparison index of large public pension funds, according to PERS' consultant Wilshire Associates. It is even further below the total fund return for the STRS for this period, which was 11.76 percent. (The STRS spends substantially smaller portions of administrative expenditures on investment advisors than does the PERS.) Measured on a three-year basis, the PERS performance also falls behind that of its peers.

This below-average performance is due in part to PERS decisions over the past several years to invest heavily in real estate. The most recent valuation of the PERS portfolio (October 1992) shows that the market value of PERS' real estate equities has declined by \$470 million (8.8 percent) from the book value (original cost) of \$5.4 billion. These investments were made upon the advice of real estate investment advisors, whose advice cost the PERS \$25.7 million in fees in 1991-92 alone.

The strongest part of the PERS portfolio, based on the ratio of market to book values, is a part of the portfolio that is directly managed by PERS' own staff—internally managed domestic equities (stocks). This portion of the portfolio has a current market value of \$18.6 billion, which exceeds book value by \$7.2 billion (63 percent). (To some extent, this reflects the longer average period of time over which these investments have been held. By any measure, however, performance in this area has been far better than that of real estate.) Moreover, during 1990-91 and 1991-92 the internally managed stock portfolio outperformed the stock portfolios that are managed by outside advisors (14.8 percent return versus 14.0 percent return in 1991-92).

This is not to say that outside advisors never add value to a portfolio in a cost-effective way. The return on investment from such spending can vary significantly depending on various factors (such as the point in the business cycle). The above information, however, suggests that such contracts need to be chosen carefully.

Legislative Review of Spending on Investment Advisors Is Needed

We believe legislative review of PERS spending on investment advisors is needed. Over the last decade, this spending has grown dramatically without any review through the budget process, to the point where such spending almost equals spending on all other aspects of PERS operations. Moreover, this spending has not produced clear results in the form of higher returns on investments.

Therefore, we recommend that the PERS report to the fiscal committees prior to budget hearings on its spending on outside investment advisors, including:

- An explanation of what factors are considered in determining (1) the types of investment advisors to use and (2) the level of expenditures for each.
- Bases for spending the amounts proposed for 1993-94.
- Expected return on expenditures for investment advisors compared to cost and expected return if in-house advisors were used.
- Steps the PERS will take to ensure that any future expenditures for outside investment advisors will result in more return on investments (including costs for these advisors) than if in-house advisors were used.

Increase PERS Accountability to Employee Members

We recommend that the Legislature enact legislation to require periodic adjustment of employee contribution rates to the PERS, on the same basis used for employer contribution rates, as one means to increase PERS management accountability to current employees and to have an equitable share in cost changes between employees and the state.

Under current law, employer contribution rates paid by the state and contracting public agencies rise or fall each year in response to changes in an array of factors, including assumptions and actual experience regarding inflation, rates of return on PERS investments, and spending levels for PERS administration. For example, the actual rate of return falling short of the assumed rate would be considered an actuarial loss, and would cause a compensating increase in employer contribution rates in order to maintain the actuarial soundness of PERS trust funds. On the other hand, employer contribution rates would decrease if investments performed above expectations. (To smooth out annual fluctuations, the actuarial loss is amortized over timeframes ranging from 5 to 40 years).

The net effect of changes in so many factors is difficult to predict from year to year. It is clear, however, that important factors affecting the employer contribution rates include factors that are, more or less, under the control of the PERS and for which the PERS board should be accountable (such as administrative expenditures and investment

performance). Under the current funding mechanism, however, it is the state and public agencies alone that either reap the financial rewards or suffer the financial consequences of positive or negative performance by the PERS.

This is because employer contribution rates fluctuate in response to PERS performance while employee contribution rates are fixed. As one means to increase the board's accountability to employees under the PERS, it would be appropriate for employee contribution rates to be adjusted annually on the same basis as employer contribution rates. Increasing the board's accountability in this way is particularly appropriate now that Proposition 162 has made the board, in many respects, autonomous from the Legislature.

Allowing the employee rates to fluctuate would also provide a more equitable sharing of changes in cost for the PERS benefit program. If the PERS administration properly manages the retirement system, the cost to the state as well as the employees would be reduced. On the other hand, increased costs would also be shared. As mentioned earlier, these fluctuations in costs affect only employer costs under current practice.

Although employee contribution rates are fixed at present, the Legislature has reserved the right (Government Code Section 20613) to adjust employee contribution rates "...in such amounts and in such manner as it may from time to time find appropriate." The effective date of this section was December 1, 1968. Therefore, the Legislature legally may increase or decrease contribution rates for employees who joined PERS on or after that date. For employees who joined PERS before December 1, 1968, the Legislature may let contribution rates fluctuate in response to actuarial calculations, provided rates do not exceed those specified under current law.

We believe that the benefits of increasing the PERS accountability to current employees, coupled with equitable sharing of fluctuations in costs, justify changing the current state employee/employer PERS rate setting structure. Consequently, we recommend that the Legislature enact legislation to require annual adjustment of employee contribution rates to the PERS, on the same basis used to adjust employer contribution rates, in order to increase the accountability of PERS management to system beneficiaries.

Governor's Proposal to Transfer Health Benefits Division to DPA

We withhold recommendation on the Governor's proposal to transfer administration of employee health benefits from the PERS to the DPA, pending receipt of a detailed proposal.

The Governor's Budget Summary includes a proposal to transfer administration of employee health benefits from the PERS to the Department of Personnel Administration (DPA). Technically, this proposal is at odds with the Governor's Budget and the introduced Budget Bill, which retain funding for this purpose with the PERS. According to Department of Finance staff, the budget request will be amended to reflect the proposed transfer to the DPA.

In the *Analysis of the 1985-86 Budget Bill*, we recommended that the Legislature enact legislation to make such a transfer for three reasons:

- The transfer would be consistent with the statutory responsibility of the DPA in the area of state employee benefits administration. (Under current law, the DPA administers virtually all of the state benefit programs).
- Consolidating administration of health benefits with administration of the other health-related benefits (dental, vision, employee assistance program) would enable the state to respond better to changes in the way health benefits are provided in the future.
- The transfer would enable the state to implement more successfully the State Employer-Employee Relations Act. We saw no convincing reason why the PERS board, an independent entity with no *overall* responsibility for the negotiation and administration of state employee benefits, should be in charge of this one major benefit.

In our view, the above reasons for transferring the administration of state employee health benefits are valid still. Moreover, now that Proposition 162 has made the PERS board less accountable to the Governor and Legislature, the argument to transfer negotiation/administration of health benefits is only strengthened. Although in the last couple years the PERS has improved its administration in this area (including a better job in the negotiation process to hold down increases in health premiums), we believe the state stands to benefit in the long-run by transferring this responsibility.

PERS staff have raised a concern that the state's ability to negotiate favorable premiums and benefits will be diminished by the break-up of the current "pool" of state/local employees and retirees. We see no reason, however, why this "pool" could not be kept intact by the PERS contracting with the DPA to administer health benefits for the local employees and retirees.

There are important details that would need to be addressed in any legislation to make this transfer. At the time this analysis was prepared, however, *no* detail regarding the Governor's proposal was available for the Legislature's review. Accordingly, we withhold recommendation on the Governor's proposal, including Item 1900-001-950 of the Budget Bill (PERS Health Benefits Administration), pending receipt and review of a detailed proposal.

CONTROL SECTION 3.60— PERS EMPLOYER CONTRIBUTION RATES

We withhold recommendation on employer contribution rates for retirement benefits pending final determination of the actual rates to be applied in the budget year and receipt and review of information regarding the basis for the actuarial assumptions underlying the determined rates.

This control section specifies the contribution rates for the various retirement classes of state employees in the Public Employees' Retirement System (PERS). The section also authorizes the Department of Finance (DOF) to reduce any appropriation in the Budget Bill that is in excess of the amount required as a result of any reductions in these rates. In addition, the section authorizes the DOF to require the State Controller to offset these contributions with surplus funds in the employer accounts.

Under current law, the PERS is responsible for developing employer contribution rates each year based on actuarial analyses. At the time this *Analysis* was prepared, a final determination of these rates had not been made.

Consequently, we withhold recommendation pending final determination of 1993-94 rates and receipt and review of information from the PERS regarding the basis for the actuarial assumptions underlying the determined rates.

STATE TEACHERS' RETIREMENT SYSTEM (1920)

The State Teachers' Retirement System (STRS) was established in 1913 as a statewide system for providing retirement benefits to public school teachers. Currently, the STRS serves over 445,000 active and retired teachers and community college instructors. Retirement and ancillary benefits totaling \$2.3 billion are expected to be paid from the Teachers' Retirement Fund (TRF) in 1993-94.

Overview of the 1993-94 Budget. The budget includes \$30.4 million from the TRF for support of STRS operations in 1993-94. This is a decrease of \$1.0 million (3.2 percent) from estimated current-year expenditures, and is due mainly to one-time expenditures in the current year for implementation of an alternative disability and survivor benefits program required by federal law. In addition, under a continuous appropriation authority, the STRS will spend a projected \$24.7 million for outside investment advisors. This is \$2.2 million (10 percent) more than estimated current-year expenditures for this purpose.

Implementation of Proposition 162. As discussed in the Crosscutting Issues portion of this section, passage of the California Pension Protection Act of 1992 (Proposition 162) at the November 1992 election grants to public retirement boards in the state "plenary" authority for administration of retirement systems. Unlike the PERS, the STRS at this point has not asserted that this new constitutional authority removes STRS administrative spending from legislative review and approval through the budget process. As discussed in detail in our analysis of the PERS (Item 1900), there are various issues raised by Proposition 162, including issues surrounding the budget process, that need to be addressed by implementing legislation. This legislation should clarify how administration of the STRS and its interaction with the rest of state government proceed in the wake of the proposition.

State Contributions to Teachers' Retirement Fund

State General Fund contributions to the State Teachers' Retirement System will reach \$835 million in the budget year—nearly \$90 million more than in the current year.

The STRS receives contributions from teachers and their employers totaling 16.25 percent of active teachers' payrolls. This contribution rate is not sufficient to provide for the cost of teachers' basic retirement benefits (the so-called "normal" cost of the system, which is 17.46 percent of payroll), nor does it provide for the protection of retirees'

purchasing power (a nonvested benefit). In addition, the STRS has an unfunded liability of \$11.1 billion (based on the most recent actuarial valuation in 1991) that is amortized over the next 37 years. All of these shortfalls are covered through annual transfers from the General Fund.

In total, the budget projects General Fund transfers of \$835 million to the TRF in 1993-94. These transfers are for three purposes:

- The STRS normal cost deficit and unfunded liability, as required by the Elder Full Funding Act (\$519.6 million).
- Maintenance of retirees' purchasing power at 68.2 percent of original allowances (\$257.8 million).
- Costs of retirement benefit enhancements (an adjustment for inflation and an increase in minimum retirement allowances) mandated by the state in 1979 and 1980, respectively (\$57.6 million).

Figure 8 summarizes estimated, budgeted and projected transfers, by purpose, for 1992-93 through 1994-95. The mandated cost reimbursements are included in Item 8885 of the Budget Bill (state mandates) and are counted toward the state's Proposition 98 funding guarantee for K-14 schools. The other two categories of General Fund spending, more than \$777 million in the budget year, are in addition to the amounts provided to K-14 schools under Proposition 98. We discuss these two categories in more detail below.

Figure 8

**State Teachers' Retirement System
General Fund Contributions to Teachers' Retirement Fund
1992-93 Through 1994-95**

(In Millions)

Program	1992-93 Estimated	1993-94 Budgeted	1994-95 Projected ^a
Elder Full Funding Act	\$510.8	\$519.6	\$521.7
Purchasing power protection	180.2	257.8	302.8
Mandates	56.2	57.6	57.8
Totals	\$747.2	\$835.0	\$882.3

^a Legislative Analyst's Office projections for 1994-95, assuming an average growth in covered payroll of approximately 0.4 percent.

Elder Full Funding Act. Education Code Section 23402, added by Ch 460/90 (SB 1370, Cecil Green)—the Elder State Teachers' Retirement System Full Funding Act—requires the state each year to transfer from

the General Fund to the TRF an amount equal to 4.3 percent of covered teachers' payroll for the prior calendar year. This amount is projected to be \$519.6 million in 1993-94—an \$8.8 million increase over estimated current-year transfers. Roughly \$165 million of this amount will cover the system's normal cost deficit—the shortfall between the system's normal cost of 17.46 percent of payroll and the combined employee/employer contribution rate of 16.25 percent of payroll. The remaining \$355 million is to reduce the system's \$11.1 billion unfunded liability.

Purchasing Power Protection. Chapter 115, Statutes of 1989 (SB 1407, Cecil Green), and Ch 116/89 (SB 1513, Campbell) established a statutory funding mechanism that provides purchasing power protection benefits to retired teachers. Prior to these acts, the Legislature provided purchasing power benefits primarily through General Fund appropriations in the annual Budget Act. These benefits are *nonvested* and, therefore, can be modified by the Legislature.

In the 1989 Budget Act, the Legislature appropriated \$167 million for these benefit payments from the TRF, in order to save General Fund monies in the 1989-90 fiscal year without reducing the benefit payments. The Legislature made a "contractually enforceable" promise to repay the TRF, with interest, through the funding mechanism established by Chapters 115 and 116. Under that mechanism, the Controller transfers each fiscal year from the General Fund to the Supplemental Benefit Maintenance Account (SBMA) in the TRF an amount based on specified percentages of teachers' payroll of the prior fiscal year. For fiscal year 1990-91 the transfer was based on 0.5 percent of payroll. The percentage grows by increments of 0.5 percent each year so that it stands at 1.5 percent for the current year and will be 2.0 percent in the budget year. In 1994-95 the percentage will reach a cap of 2.5 percent. It is this incremental growth in the applicable percentage that largely accounts for the significant increases in General Fund transfers that are evident in Figure 8.

General Fund Transfer to SBMA Overbudgeted

The Governor's Budget overstates the amount of General Fund monies needed for statutory transfers to the SBMA by \$16.6 million. We recommend the Legislature recognize the availability of these funds as part of the Legislature's budget solution (General Fund savings of \$16.6 million).

The budget projects General Fund transfers to the SBMA of \$257.8 million in 1993-94—a \$77.6 million increase (43 percent) over estimated current-year transfers. This increase is due to the interaction

of two factors in the transfer formula specified in statute: (1) the estimated growth in teachers' payroll from 1991-92 to 1992-93 and (2) an increase in the percentage that is applied to that payroll from 1.5 percent to 2.0 percent (as discussed above).

Our analysis indicates that the budget overstates the amount of General Fund monies that need to be transferred in 1993-94, by over-estimating growth in teachers' payroll. The budgeted transfer amount is based on an assumption that teachers' payroll will grow by 7.3 percent from *fiscal year* 1991-92 to 1992-93. (Under law, 1992-93 payroll is used for the 1993-94 transfer calculation.) This projection is inconsistent with recent statewide trends in teachers' payroll. For example, actual payroll growth from 1990-91 to 1991-92 was only 1.7 percent (compared to growth the previous year of 7.7 percent). Data for calendar year 1992 indicates that payroll growth rates have decelerated further. For instance, the budget estimates that payroll growth from *calendar year* 1991 to *calendar year* 1992 was only 0.4 percent. (Calendar-year, rather than fiscal-year, payroll is used for calculating General Fund transfers required by the Elder Full Funding Act.) These low growth rates are not surprising, given the current fiscal problems of school districts across the state.

There is no evidence to support the 7.3 percent payroll growth used to determine the General Fund transfer to the SBMA. This assumption needlessly sets aside General Fund resources that the Legislature could use to help address the state's budget problem. Consequently, for purposes of projecting statutory transfers to the SBMA, we recommend that the Legislature assume that growth in teachers' payroll from 1991-92 to 1992-93 will not be greater than the 0.4 percent rate of growth from calendar year 1991 to calendar year 1992. Revising this assumption would free up approximately \$16.6 million for other state purposes in 1993-94. We recommend the Legislature recognize the availability of these funds as part of the Legislature's budget solution.

Redefining the State's Role in Teachers' Retirement

We recommend that the Legislature enact legislation to establish a benefit plan for future entering members of the STRS that is funded fully by member and employer contributions on an actuarially sound basis. The state would experience major General Fund savings in future years by eliminating the state's financial liability for new teachers. These savings would grow each year, as current teachers retire, to an eventual annual level of roughly \$400 million (in today's dollars).

Teacher and school district contribution rates are fixed by law at levels that fall short of what is required to provide for ongoing

retirement benefits. These provisions for teachers' retirement impose major costs on the state's General Fund. In fact, through the funding mechanisms established by current law, the state actually underwrites a large share of the costs of teachers' retirement. In no other instance is the state responsible for retirement costs for nonstate employees/retirees.

Given that the member beneficiaries of the STRS are local, rather than state, employees, as well as the independence accorded to the STRS board by Proposition 162, it is not clear, as a matter of public policy, why the state should continue to be responsible for the normal cost deficit of the system. The normal cost deficit is the difference between the combined employee/employer contribution rate (16.25 percent of payroll) and the rate required to provide for ongoing retirement benefits on an actuarially sound basis (currently 17.46 percent of payroll). This deficit accounts for annual General Fund costs of roughly \$165 million.

With respect to *current* members of the system, there is virtually nothing the state can do about the normal cost deficit. Under case law regarding contracts, the state can neither increase the member contribution rate above 8 percent nor reduce retirement benefits. In addition, any increase in the school district contribution rate would not relieve the General Fund, since it would probably create a mandated local cost that is reimbursable by the state.

The Legislature does, however, have the option of changing contribution rates and benefits for *new* teachers who enter the retirement system in the future, and it is here that efforts for fundamental changes in the financing of the system must be focused.

With respect to future members of the STRS, we recommend that the Legislature enact legislation to establish a benefit plan that is fully funded by member and employer contributions on an actuarially sound basis. This objective may be achieved by one or more measures, including:

- Voluntary—or bargained—increases in employer contributions.
 - Increases in member contribution rates.
 - Reductions in benefits.
 - Teacher participation in social security as a partial substitute for STRS benefits.
 - Participation in defined contribution plans as a partial substitute for STRS benefits. Defined contribution plans—under which
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employees choose amounts of salary to be deferred and invested on a tax-deferred basis—offer not only a means of reducing state costs but also offer a flexible means of accommodating varying financial goals among individuals.

The Legislature could even establish a variety of plans—with different benefit levels, contribution rates, and cost-of-living provisions—from which districts and teachers could choose. Under any plan, however, the state would have *no* liability for school district retirement costs. This would be solely a local decision, as are all other compensation issues.

The state would experience major General Fund savings in future years by eliminating the state's financial liability for new teachers. These savings would grow each year, as current teachers retire, to an eventual annual level of roughly \$400 million (in today's dollars). This estimated amount includes about \$165 million for elimination of state responsibility for normal cost deficit and about \$235 million for eliminating state costs for purchasing power payments.

Options to Reduce General Fund Expenditures in 1993-94

Although there is little the Legislature can do to reduce state costs related to vested benefits of current STRS members, the Legislature could reduce STRS-related General Fund expenditures in the budget year by suspending or reducing the purchasing power benefit payments.

As discussed above, Chapters 115 and 116 of 1989 established a statutory funding mechanism that provides purchasing power protection benefits to retired teachers. A portion of the General Fund amount for this program is part of a legislative promise to repay the TRF for purchasing power benefit payments in prior years, and a portion is for current purchasing power protection benefits. The enacted legislation expressly states that these supplemental benefits are *nonvested* and reserves the right of the Legislature to reduce or terminate the benefit program at any time.

Approximately 55,000 teachers who retired before 1980 receive purchasing power benefit payments. These payments range from an average of \$8 per month for teachers who retired just before 1980 to an average of about \$470 per month for teachers who retired between 1959 and 1973. These supplemental benefits come on top of the vested retirement benefit amounts for these groups, which average \$733 and \$460 per month, respectively. In total, purchasing power benefit payments are expected to cost the General Fund \$226 million in 1993-94.

The Legislature could save significant General Fund amounts by reducing, on a one-time basis, the benefit levels for 1993-94. For example, we estimate that roughly \$75 million could be saved if benefit payments for 1993-94 were set at maintaining allowances at 60 percent of original purchasing power instead of the current target of 68.2 percent.

DEPARTMENT OF PERSONNEL ADMINISTRATION (8380)

The Department of Personnel Administration (DPA) manages the *nonmerit* aspects of the state's personnel system. The Ralph C. Dills Act, formerly known as the State Employer-Employee Relations Act, provides for collective bargaining for most state civil service employees. Under the Dills Act, the DPA, in cooperation with other state departments, is responsible for (1) reviewing existing terms and conditions of employment subject to negotiation, (2) developing management's negotiating positions, (3) representing management in collective bargaining negotiations, and (4) administering negotiated memoranda of understanding (MOUs). The DPA is also responsible for providing for the compensation, terms, and conditions of employment of managers and other state employees who are not represented in the collective bargaining process.

The budget proposes total expenditures of \$12.6 million for support of the department in 1993-94. This is \$366,000, or 3.0 percent, more than estimated current-year expenditures. The proposed expenditures include \$6.1 million from the General Fund, \$4.4 million from reimbursements, and \$2.1 million from other state funds.

Employee Compensation

During 1992, the DPA entered into memoranda of understanding (MOUs) with 20 of the 21 employee bargaining units. These MOUs call for pay increases that will cost the state an estimated \$234 million in the budget year and substantially larger amounts annually thereafter.

During 1992, all but one of the 21 state employee bargaining units entered into MOUs with the state. Bargaining Unit 14 (printing trades) remains at a negotiating impasse with the state. The various MOUs have been ratified by the Legislature through six bills chaptered in 1992. The major elements of the MOUs are as follows:

- **Personal Leave Program.** The MOUs terminate, effective January 1994, the mandatory one-day-per-month pay reduction (approximately 4.67 percent) that is currently in effect. Through this mechanism, the state is deferring salary and wage costs. Employees are compensated by time credits that will be payable later in cash (under specified circumstances) or time off (similar to earned vacation leave).
- **Salary Increase.** For covered employees other than Bargaining Unit 6 (correctional employees) the MOUs provide a five percent pay increase effective January 1, 1994. The MOU for Bargaining Unit 6 provides a 5 percent pay increase, effective June 30, 1993. The budget includes \$234 million (\$134 million General Fund) for the 1993-94 costs of these pay increases (and pay increases for nonrepresented employees) under Item 9800—augmentation for employee compensation. We discuss the pay increases in further detail in our analysis of that item. In addition, all the MOUs call for a further pay increase of 3 percent to 5 percent (depending on inflation) in January 1995.
- **Cost for Health Benefits.** The state's maximum contribution for the cost of an employee's health benefit premium is held at the 1991-92 level. The state's contribution will be capped at this level through 1994-95, unless premiums increase by more than 30 percent above 1991-92 costs. Thus, up to the 30 percent premium increase, the maximum monthly state contribution will remain \$174 for an eligible employee, \$323 for an employee and one dependent, and \$410 for an employee and two or more dependents. Currently, the PERS is negotiating premium rates for 1993-94.

Potential for Layoffs of State Employees Uncertain

Based on experience to date, it is unclear if additional layoffs will be necessary. Therefore, we recommend that the DPA and the State Personnel Board report at budget hearings on the status of and the potential need for layoffs in the current and budget years.

From June 30, 1991 through February 5, 1993, a total of 160 people in 19 departments have been laid off. These numbers, however, do not adequately depict the changes that are occurring in the state workforce. In fact, these numbers represent a relatively small portion of the total number of employees that have been affected by the state's layoff procedure through demotion, retirement, transfer to another state agency, or separation prior to layoff. For example, the DPA indicates that approximately 1,100 employees from 22 departments currently are

on State Restrictions of Appointment (SROA) lists, according them priority for hiring by other departments. These employees have been designated as "surplus" to the needs of their own departments and therefore face potential layoff or demotion. It is unclear how many of the employees on SROA lists will be laid off.

Adding to the uncertainties facing the state workforce is the \$150 million of unspecified reductions in state operations proposed in Control Section 3.90 of the Budget Bill. Almost certainly, this will result in additional employees being designated as "surplus" and, therefore, facing potential layoff or demotion. Given the uncertainty concerning the status of or need for layoffs, we recommend that the DPA and the State Personnel Board report to the Legislature during budget hearings on this issue.

Transfer of Health Benefits Administration from PERS

We withhold recommendation on the Governor's proposal to transfer administration of employee health benefits from the Public Employees' Retirement System (PERS) to the DPA, pending receipt of a detailed proposal.

In our analysis of the PERS budget (Item 1900), we discuss the Governor's proposal to transfer administration of employee health benefits from the PERS to the DPA. The budget, as introduced, is internally inconsistent in proposing this transfer while (1) retaining funding for health benefits administration in the PERS and (2) not providing funding to the DPA. Department of Finance staff indicate that a Budget Change Letter will be sent to the Legislature to make proposed funding consistent with the proposed transfer.

At the time this analysis was prepared, no detail regarding the transfer proposal was available for the Legislature's review. We therefore withhold recommendation, pending receipt and review of a detailed proposal.

HEALTH AND DENTAL BENEFITS FOR ANNUITANTS (9650)

This appropriation provides for the state's contribution toward the monthly health and dental insurance premiums for annuitants of the Judges', Legislators', District Agricultural Employees', and Public Employees' Retirement Systems (PERS), as well as selected annuitants of the State Teachers' Retirement System. The program provides eligible

members with the option of selecting insurance coverage from as many as 27 state-approved health providers.

Government Code Section 22825.1 expresses legislative intent that the state pay an average of 100 percent of health insurance premiums for annuitants, and 90 percent of the health insurance costs for their dependents. The State Employees Dental Care Act does not express the same intent with regard to the state's contribution toward annuitants' dental insurance costs. The state, in practice, also pays 100 percent and 90 percent of dental premium costs for annuitants and their dependents, respectively.

Overview of the Budget Request

We withhold recommendation on the \$330.1 million requested from the General Fund for Health and Dental Benefits for Annuitants pending final determination of premium rates.

The budget proposes total expenditures of \$330.1 million from the General Fund for health and dental benefits for annuitants in 1993-94. This is \$31.9 million, or almost 11 percent, more than estimated expenditures for this purpose in the current year. This increase is due solely to increases in the numbers of covered annuitants. The total needed for the budget year could change on the basis of health and dental premiums for 1993-94 that are currently being negotiated between the state and providers. Pending final determination of these premium rates, we withhold recommendation on the amount requested under this item.

CONTROL SECTION 4.00— HEALTH INSURANCE PREMIUMS

We withhold recommendation on the monthly state contribution rates for annuitant health insurance specified in this section, pending final determination of the actual health insurance premium rates to be charged in the budget year.

This control section specifies the maximum monthly amounts that the state contributes toward the cost of its employees' and retirees' health insurance.

Pursuant to ratified memoranda of understanding with 20 of the 21 employee collective bargaining units, this section sets the maximum rates for active employees at the 1991-92 level. These monthly amounts

are \$174 for the employee only, \$323 for an employee and one dependent, and \$410 for an employee and two or more dependents.

With regard to retired state employees, the budget proposes the following maximum monthly contributions: \$184 for a retiree only, \$341 for a retiree and one dependent, and \$435 for a retiree and two or more dependents. These amounts are based on current-year premium rates. They are based also on legislative intent, expressed in Government Code Section 22825.1, that the state pay an average of 100 percent of health insurance premiums for annuitants and 90 percent of the health insurance costs for dependents.

At the time this analysis was prepared, the Public Employees' Retirement System (PERS) was negotiating with health care providers to establish 1993-94 health insurance premium rates for the state. The appropriate state contributions for annuitants could, therefore, change. Consequently, we withhold recommendation on Control Section 4.00, pending final determination of the health insurance premium rates.

AUGMENTATION FOR EMPLOYEE COMPENSATION (9800)

This item provides for the 5 percent pay increase for state employees as called for in memoranda of understandings approved in 1992. The amount also provides for a 5 percent pay increase for nonrepresented state employees.

The budget proposes four appropriations totaling \$234 million for compensation increases for all state employees except those in higher education. (Salaries for employees in higher education are contained in separate budget appropriations). The General Fund appropriations equal \$134 million, or 57 percent, of the total.

Memoranda of Understanding Provide for Salary Increase. The proposed compensation increases are to provide a 5 percent general pay increase for state employees. Memoranda of understanding (MOUs) between the state and 19 of the 21 employee bargaining units call for these pay increases to take effect January 1, 1994. The Department of Personnel Administration (DPA) has also approved a 5 percent pay increase for nonrepresented employees to take effect on the same date. The MOU for Bargaining Unit 6 (correctional employees) provides for a 5 percent pay increase to take effect June 30, 1993. No MOU has been negotiated yet with Bargaining Unit 14 (printing trades) and therefore no pay increase has been approved for those employees. Figure 9

summarizes the associated compensation increases budgeted for the above employee groups, by General Fund, special funds and nongovernmental cost funds.

Figure 9

Augmentation for Employee Compensation Budgeted Expenditures by Employee Group and Fund 1993-94

(In Thousands)

Employee Group	General Fund	Special Funds	Nongovernmental Cost Funds	Totals
Represented:				
Correctional (unit 6)	\$33,653	—	—	\$33,653
All other represented	69,527	\$41,600	\$38,400	149,527
Nonrepresented:	30,820	10,400	9,600	50,820
Totals	\$134,000	\$52,000	\$48,000	\$234,000

Cost Implications for 1994-95. For all employees, other than those in Bargaining Unit 6, the general pay increases take effect midway through the budget year. We estimate that the full-year costs of the pay increase provision would be approximately \$435 million (\$235 million General Fund), beginning in 1994-95. In addition, the MOU's provide for a 3 to 5 percent pay increase (depending on inflation), effective January 1, 1995. Additional costs of between \$145 million and \$240 million would be attributable to this provision, resulting in estimated 1994-95 costs for compensation increases of \$580 million to \$675 million (General Fund costs ranging from about \$315 million to \$370 million).

Legislature Has Option to Save More Than \$200 Million in 1993-94

The Legislature has the option of saving more than \$200 million (including \$100 million General Fund) in 1993-94 by not funding the 5 percent general pay increases budgeted for state employees (other than those represented by Bargaining Unit 6—correctional employees).

Each of the six bills enacted to ratify the 20 negotiated MOUs includes a section specifying that any MOU provision which is scheduled to take effect on or after July 1, 1993, and which requires the expenditure of funds, shall not take effect unless funds for these provisions are specifically appropriated by the Legislature. Each measure further states that in the event funds for any of these

provisions are not appropriated, the state and the affected employee organizations shall renegotiate the affected provisions.

As a result, the 5 percent pay increases for all employees other than those in Bargaining Unit 6 (whose pay increase takes effect June 30, 1993) are conditioned on the Legislature appropriating the funds requested under this item. Thus, the Legislature has the option of saving more than \$200 million in 1993-94 (including \$100 million General Fund) by not funding the general pay increases. Alternatively, the Legislature may save lesser amounts by providing for smaller general pay increases.

BOARD OF EQUALIZATION (0860)

The Board of Equalization (BOE) is one of the state's two major tax collection agencies. It collects state and local sales and use taxes and a wide variety of business and excise taxes and fees. The board also oversees the administration of the property tax by county assessors and assesses property owned by public utilities that spans more than one county. Finally, the board is the final administrative appellate body for personal income and bank and corporate taxes.

The proposed budget for the BOE maintains baseline expenditures for its programs and moderately increases expenditures on (1) audit and collection staff, and (2) its central data processing system. The budget proposes to increase the board's General Fund appropriation by \$22 million, or 16 percent, over current-year expenditures. The majority of this increase, \$14.4 million, reflects a shift of funding support for the board's local property tax programs from cigarette tax revenue to the General Fund.

Separate Budget for Board and Appeals Function Will Enhance Oversight

We recommend that the Legislature create a new line item in the budget for the support of the board members and the appellate function. (Add Item 0861-001-001 to appropriate \$7.15 million for board support and appeals workload, and reduce Item 0860-001-001 by \$7.15 million.)

As noted in the *Overview* to this section, we have long recommended the creation of a Department of Revenue. The budget does contain a proposal to consolidate the tax administration responsibilities of the board with similar functions performed by the Franchise Tax Board (FTB) into a new Department of Revenue (please see discussion of this

issue in the Overview section). While the budget does not describe the details of this proposal, preliminary information indicates that the BOE would continue to perform its existing appellate function for Personal Income, Sales and Use, Bank and Corporation, and other tax programs. This consolidation of tax administration responsibilities is consistent with our prior recommendations on this topic.

Regardless of whether any action is taken on the consolidation issue, we believe that a separate line item for the board and its appeals function makes good sense. Specifically, a separate budget will provide the Legislature with better information regarding the costs associated with the tax appeals function (and board member staffing levels), and allow it to better monitor the effects of tax policy changes on appeals workloads.

Accordingly, we recommend that the Legislature create a separate line item appropriation for (1) board members' expenses, (2) their immediate staff, and (3) the tax appeals staff. Currently, 28 personnel are assigned to assist board members with their responsibilities. The board members, together with their immediate staff, currently require an appropriation of approximately \$3 million annually. In addition, approximately 50 personnel of the board's legal division are assigned to support the board's tax appeal process, at a cost of approximately \$4.15 million annually. Funding these costs separately requires a line item appropriation of \$7.15 million. This appropriation should be completely offset by a reduction of \$7.15 million to the board's overall budget (Item 0860).

Better Management of Position Vacancies Needed Instead of Increased Funding

The board cannot show how increased funding for personal services will lead to reduced vacancy rates in audit and compliance positions. As a result, we recommend that the proposed increase be denied. (Reduce Item 0860-001-001 by \$1.5 million.)

The budget proposes to reduce budgeted salary savings for audit and compliance positions (at a cost of \$1.5 million).

Proposed Salary Savings Reduction Not Justified. Under existing state budget procedures, each agency's budget contains an offset to account for the fact that a portion of its positions will be vacant during the year as a result of normal employee turnover. This offset is called salary savings. Each agency must ensure that enough positions are actually vacant during the year to avoid over-spending its budget. The amount of budgeted salary savings differs between agencies, according

to their past histories and legislative and administrative preferences for levels of savings.

Board staff argue that, in order to absorb unbudgeted cost increases, such as employee health care costs, the board has been forced to maintain an artificially high number of vacancies to avoid overspending its budget. Specifically, the board must hold approximately 4.5 percent of its positions vacant. The board argues that this is substantially higher than the rate of 3.5 percent which would reflect its normal expectation for employee turnover. The budget proposal would allow the board to maintain a vacancy rate of 3.5 percent, on average, across all board activities.

The board indicates that it would actually use the additional funding almost exclusively to reduce vacancies in its audit and compliance functions, rather than across-the-board. By achieving lower-than-normal salary savings in these areas, the board argues that it can produce an additional \$6 million in General Fund revenue.

Preliminary data indicate, however, that the actual vacancy rate for audit and compliance positions is now approximately 6.5 percent—significantly higher than the 4.5 percent budgeted rate for *all* positions, and more than twice what the board states it will achieve if this funding is provided. By holding 6.5 percent (rather than 4.5 percent) of its audit and compliance positions vacant, the board has, in effect, *redirected* approximately \$1.6 million that the Legislature intended to go for audit and compliance activities to other activities. Board staff explain that this higher rate is the result of cumbersome personnel hiring procedures and other administrative difficulties *not related to its problems with unbudgeted costs* and that, over time, the actual vacancy rate would be lowered from the current 6.5 percent rate to about 3 percent.

Since the board's *actual* vacancy rate for these critical positions is higher than the *budgeted* rate, however, we question the board's ability to actively lower vacancies among its audit and compliance staff.

In response to our queries, board staff could identify no specific actions that would be taken to reduce the number of audit and compliance vacancies. In our view, it appears that the board could reduce vacancies in audit and compliance positions by (1) delegating salary savings management authority to field managers and (2) streamlining the hiring process for auditors and collection staff.

Pending the development by the board of a specific plan for achieving these reductions and data which would indicate that progress is being made to reduce the vacancy rate with *existing funds*, we see no

need at this time for higher funding levels. Therefore, we recommend deletion of the funds requested for reducing the board's budgeted salary savings.

Audit Gains Overstated

The budget substantially overstates the benefit-to-cost ratio from adding new audit staff.

The Legislature has, in the past, directed the board to select accounts for audit in a way that ensures that audit resources are allocated to the most productive accounts. Because of this selection policy, *any* increase in audit staffing levels will produce an incrementally lower amount of revenues per auditor than is currently collected. The Legislature has generally followed a policy of providing additional audit resources until the amount of revenue returned per dollar of cost equals five-to-one for the last additional auditor (the marginal recovery rate).

Revenue Gains Are Overstated. It appears, however, that the board has overstated revenue gains from recent audit staff augmentations, for at least two reasons. First, based on results from audits of business activities that occurred in 1989-90, the board asserts that its marginal recovery rate is five-to-one. In our view, however, using three-year-old data overstates current productivity levels by significant amounts, because these data fail to account for subsequent staff augmentations. The audit staff augmentation in the 1992 Budget Act increased the board's audit staff by 150 auditors, or 17 percent. Although the board's studies confirm that the productivity of audits decreases as more audits are conducted, the board asserts that its productivity level is still five-to-one, even after this unprecedented increase in audit staff.

Second, our analysis of the board's management of salary savings (see previous issue) indicates that the board holds relatively more audit positions vacant than positions in other areas of board operations. As a result, revenue projections for new auditors also are overstated to the extent that funding for new auditors is actually redirected to other activities.

Although this overstatement has no effect on the overall budget's revenue totals, it is misleading in the context of evaluating requests for additional auditors. As a result, we believe the Legislature should take into account these factors when evaluating new requests for additional auditors, including the current proposal related to use fuel tax auditors.

Current Proposal Overstates Revenue Gains. The budget proposes \$2.8 million in 1993-94 to "increase" board audit efforts to identify use fuel tax evasions. The use fuel tax is a state excise tax placed on diesel

fuel. The budget request is actually a continuation of funding provided in the current year, pursuant to a revenue enhancement package passed by the Legislature in conjunction with the 1992 Budget Act (Ch 708/92, AB 3225—No Author).

According to the budget, this proposal will result in approximately \$31 million in new revenue (\$12 million General Fund, \$12 million special funds, and \$7 million to local governments). If this revenue estimate is correct, the proposal will have a revenue-to-cost ratio of approximately 11-to-1. Our analysis indicates, however, that actual revenue gains from continuing the current-year expansion of audit staff will be, at best, less than *one-half* of the budget's estimate.

Due to the high productivity of the diesel fuel audits, the board has already reassigned audit personnel in the current year away from less productive audits to fuel tax audits. This reassignment would have been accomplished, consistent with existing audit selection policies, *regardless of the audit staff augmentations funded in 1992.*

In reality, the 50 new auditors hired pursuant to the funding provided by AB 3225 will be used to *replace* the coverage of less productive accounts (that is those with ratios of less than five-to-one) that occurred when existing auditors were reassigned to use fuel audits. In effect, the budget proposal amounts to a request to continue funding audit coverage of those less productive accounts and, as indicated above, the marginal recovery rate for this coverage is less than 5 to 1.

Teale Migration Not Working Out

We recommend that the Legislature take steps to explore the feasibility of transferring the board's central data processing activities to the Franchise Tax Board.

The budget requests an augmentation of \$600,000 to offset unanticipated data processing costs associated with the board's use of the Teale Data Center (TDC). In 1991-92, the board began an effort to relocate its central data processing from a mainframe computer funded and operated by the board to the TDC. As with other state agencies, the TDC charges the board for the direct costs of data processing and storage. This migration of the board's data processing support was originally justified on the basis that it would allow the board to more effectively administer its tax programs and more efficiently absorb increases in processing workload.

Data Processing Costs at TDC Far Greater Than Originally Projected. The first phase of this migration was completed in July 1992. A preliminary analysis by board staff indicate, however, that

reimbursement costs for using the TDC's processing facilities are significantly *above* initial projections. In 1993-94, for example, board staff estimates that these costs will be approximately \$600,000 *above* original projections. As a result, the board intends to reconsider its effort to relocate its data processing activities to the TDC during the budget year.

We concur with the board that a thorough reevaluation of its central data processing plans is necessary. Because the FTB has been successful in managing its own in-house mainframe computer systems, we recommend that the Legislature request the board to also evaluate the feasibility of purchasing central data processing system support from the FTB. We have requested the FTB to provide an estimate of costs it would incur in the budget year to assist the board with this evaluation.

New Formula for Reimbursements Proposed

The budget proposes enactment of legislation to increase General Fund reimbursements from local governments by approximately \$12 million in the current year and \$13 million in the budget year to fully compensate the board for its administration of local sales taxes.

Before the board distributes sales tax revenues to local agencies, it deducts an amount to cover a portion of its administrative costs. This amount equals a fixed percentage (set by statute) of the *revenues* produced by the tax. These charges reduce, on a dollar-for-dollar basis, the amount of General Fund support needed by the board.

The objective of the reimbursement formula in current law is to ensure that the board's cost to administer local taxes are fully recovered. Legislation enacted in 1991 altered the reimbursement formulas to reflect the board's full cost at that time. However, since the formulas are based on a fixed percentage of sales tax revenue, the reimbursements will not cover the board's costs when taxable sales decline, as has been the case in the current year.

Budget Proposes New Methodology for Reimbursements. The board's proposed funding includes reimbursements of \$64.4 million in the current year and \$67 million in 1993-94 from local sales tax revenues. These reimbursements, however, are based on the board's estimate of the cost to administer local sales taxes, as opposed to the reimbursements produced by the existing percentage-of-revenue formula.

The Administration will seek legislation that would base reimbursements for the current and budget years on the board's costs.

The budget, however, does not contain any details describing the proposed change in the reimbursement formula.

Prior Proposal Recovered Actual Costs. During the 1991-92 Regular Session of the Legislature, the Administration supported legislation (AB 2625, Baker) which adjusted the reimbursement formulas so that the board would recover actual costs of administering local taxes. This legislation would have allowed the board to reduce quarterly distributions of local sales tax revenue by an amount equal to the board's costs of administering its local tax programs. The board would estimate its costs in the annual Budget Bill and actual reimbursements would be adjusted at the end of the year to reflect actual costs.

While this approach of collecting reimbursements appears to be analytically sound, it would result in additional costs to local governments during the current year (\$11.7 million) and budget year (\$12.7 million). These additional costs occur because reimbursements calculated under current law are less than the board's costs. If the Administration is not successful in passing legislation to change current law, the board's budget for local sales tax administration would be underfunded by \$11.7 million in the current year and \$12.7 million in the budget year.

FRANCHISE TAX BOARD (1730)

The Franchise Tax Board (FTB) is one of the state's two major tax collection agencies. The FTB is responsible for administering California's Personal Income Tax, Bank and Corporation Tax, Homeowners' and Renters' Assistance programs, and the Political Reform Act audit program. The FTB consists of the Director of Finance, the Chair of the State Board of Equalization, and the State Controller. An executive officer is charged with administering the FTB's day-to-day operations, subject to supervision and direction from the board.

The budget proposed for the Franchise Tax Board essentially maintains the current-year level of expenditures for its programs. However, the proposed General Fund appropriation is \$5.5 million less than the current-year appropriation. The reduction in the FTB's General Fund appropriation is primarily attributable to (1) an increase in reimbursements which offset filing enforcement and collections costs and (2) savings attributable to full implementation of the Taxpayer Information data processing system.

Budget Double-Counts New FTB Fees

We recommend that the Department of Finance correct for the double-counting of new FTB fees in 1993-94 by treating the fees as General Fund revenue.

In 1992, legislation was enacted (Ch 699/92, SB 617, no author) which requires the Franchise Tax Board (FTB) to collect fees from Personal Income (PIT) and Bank and Corporation (B&C) taxpayers who do not voluntarily pay their tax liabilities or who do not voluntarily file tax returns. The purpose of this legislation is to recover state costs associated with taxpayers who fail to comply with filing and payment deadlines. FTB staff estimates that revenue from these fees will be roughly \$15 million in the current year, and approximately \$26 million in 1993-94.

Chapter 699 provides that revenue collected from these fees in 1992-93 be treated as a reimbursement, so that it directly offsets the FTB's General Fund appropriation for filing enforcement and collection activities. As a result, using authority provided in Section 3.90 of the 1992 Budget Act, the administration *reduced* the FTB's budget for the current year by \$15 million, by increasing the amount reflected as reimbursements for FTB's filing enforcement and collection activities. In preparing the 1993-94 Budget, however, the administration also included an additional \$20 million in the budget's estimate of 1992-93 General Fund revenues to reflect collection of these fees. By reducing the FTB's budget *and* simultaneously increasing its revenue estimates, the administration has overstated the effect of the new fees in the current year by \$20 million.

Budget's Accounting of Fee Revenue as Reimbursements in 1993-94 Is Inappropriate. Looking at 1993-94, we find that the budget again double-counts the revenue from enforcement and collection fees. Specifically, the budget reduces the FTB's General Fund appropriation (through increased reimbursements) by a total of \$26 million to reflect the full-year cost of filing enforcement and collection activities. The administration also has increased its revenue estimates by \$26 million to reflect revenue from the fees.

The apparent intent of Chapter 699, however, is for fee revenue to be counted as additional tax revenue beginning in 1993-94, and not as reimbursements to the FTB's budget. Based on discussions with legislative staff, the treatment of these fees as revenue rather than reimbursements in 1993-94 and thereafter was intended to provide the Legislature with additional oversight on the administration of the fees.

In our view, however, the treatment of fees as revenue appropriately insulates the board's budget from potential problems associated with estimating the level of fee revenues. For example, the fee revenue estimates do not take into consideration the possibility that the fees will motivate taxpayers to comply with filing enforcement and collection deadlines to avoid the fees. If a greater portion of taxpayers comply with deadlines, fee revenue would be far less than the FTB's projections. Similar problems with estimating local sales tax reimbursements has resulted in the need for constant adjustments (both deficiencies and appropriations) of the Board of Equalization's budget.

Therefore, we recommend that the Department of Finance, when correcting for the budget's 1993-94 double-counting problem, implement the intent of Chapter 699 by treating these fees as revenues.

Basis for Filing Enforcement Fee Is Not Clear

We recommend that the FTB report to the Legislature at budget hearings as to the costs attributable to filing enforcement activities on businesses so the Legislature can establish fees for 1993-94.

Chapter 699 requires that the fees for 1993-94 and subsequent years be set in the Budget Bill, and the Budget Bill includes a provision establishing the 1993-94 fees at a level identical to the level set for 1992-93. It appears, however, that the FTB may have overstated the level of its costs attributable to filing enforcement activities on businesses. As a result, the FTB is re-evaluating (1) its estimates of the costs and (2) whether the proposed 1993-94 filing enforcement fee for B&C taxpayers is too high. If the FTB determines that these fees are too high, then the Legislature will need to reduce the fees in the 1993-94 budget bill. In order to enable the Legislature to establish the appropriate level for these filing enforcement fees, we recommend that the FTB report at budget hearings as to its findings on the costs of filing enforcement activities.

FTB's Costs to Eliminate Renters' Tax Credit Not Budgeted

We recommend that the FTB report to the Legislature at budget hearings as to the administrative cost impacts that would result from eliminating the Renters' Tax Credit for the 1992 and 1993 tax years.

As a part of the Governor's plan to address the state's fiscal dilemma, the budget proposes the elimination of the Renters' Tax Credit (Renters' Credit) program for both the 1992 and the 1993 tax years (please see Item 9100 for further discussion of this proposal). This program provides a "refundable" tax credit to moderate- and low-

income Californians who rent their principal place of residence for at least six months of the tax year. In conjunction with processing Personal Income tax (PIT) returns, the FTB processes and validates requests for this credit.

FTB Will Not Adjust Return Processing. On February 4, the FTB voted to process 1992 tax returns with Renters' Credit claims as if the program were to continue. As a result, 1992 tax returns with Renters' Credit claims will be processed by the FTB as they are received. For taxpayers who claim the credit and are owed a refund, this action means that their refund will not be delayed as a result of the uncertainty regarding the credit.

While this action provides administrative direction to FTB managers and avoids delays in refund payments to taxpayers, it eliminates the least expensive alternative to implement the Governor's proposal to abolish the Renters' Credit program for tax year 1992. This least-cost approach would have been to delay processing 1992 tax returns which claimed the credit and are owed a refund until the Legislature makes a decision on the program. If the Legislature were to adopt the proposal now, the FTB would have to send deficiency notices to the more than 4 million 1992 taxpayers who will claim the credit. Sending these notices would result in significant additional processing and collection costs in both the current and budget years, and it is likely that some portion of the credits paid to taxpayers could not be recaptured.

Uncertainty Likely to Impair Effectiveness of Taxpayer Assistance System. Whether the proposal is adopted for 1992 or not, its existence is likely to cause confusion among PIT taxpayers. The FTB maintains a taxpayer assistance program to respond to both written and oral inquiries regarding tax return preparation. A central component of this program is the toll-free Telephone Information Center. Currently, the FTB's budgeted service level (that is, response rate) for general questions is roughly 50 percent. In other words, the center handles about half of the incoming calls on any given day.

It is likely there will be a significant number of additional calls to the Information Center regarding the status of the Renters' Tax Credit. This will result in a decline in the actual service level of the Information Center. To the extent that potential taxpayers are frustrated in their attempts to contact the FTB, their compliance with the state's tax laws will be reduced. Such a reduction in compliance would lead to additional tax processing and/or collection costs.

Costs in 1993-94 Reduced. While there are certain to be additional costs in the current year in the event this program is terminated, its elimination would result in a *reduction* in FTB's 1993-94 PIT tax return

processing workload. In our view, this reduction should result in cost savings both in 1993-94 and in subsequent years, but no such administrative cost savings have been included in the budget. Therefore, we recommend that the FTB report to the Legislature at the time of budget hearings as to the cost implications of eliminating the Renters' Tax Credit program for both 1992-93 and 1993-94.

Settlement Authority Appears to Be Good Policy

We recommend enactment of legislation that permanently provides the FTB with the authority to settle civil tax disputes with PIT and B&C taxpayers.

In 1992, Ch 449/92 (AB 887, Mays) was enacted to authorize the FTB to negotiate settlements to existing PIT and B&C tax disputes. The authority provided by this legislation can be exercised only during 1992-93 and only on cases that had been protested or appealed prior to July 1992. The budget estimates that this authority will result in a \$300 million revenue gain for 1992-93, and revenue losses of approximately \$35 million annually beginning in 1993-94 and continuing for up to 10 years.

Tax disputes typically result from taxpayers protesting or appealing the results from an audit conducted by the FTB. These disputes can be resolved on the basis of facts or interpretation of law, and each issue in dispute must be determined entirely in favor of or against the taxpayer. The intent of the Legislature was to allow the FTB to resolve a dispute on the basis of the "hazards of litigation"—in essence, a consideration of the probability that the FTB's position would be sustained by future court decisions. Similar authority is granted to the Internal Revenue Service to resolve federal tax disputes.

Settlement Authority Is Well Received. The primary purpose of enacting Chapter 449 was to generate additional tax revenue in 1992-93. Initial reactions indicate, however, that the program appears to be well received by FTB staff, tax practitioners, and taxpayers. Specifically, FTB staff indicate that they are receiving far more requests from taxpayers to have their disputes considered for settlement than had been anticipated. In addition, FTB staff indicate that the program will meet the Legislature's objective of increasing revenue cash flow in 1992-93 by \$300 million.

Settlement Authority Is Good Tax Policy. While the program enacted by Chapter 449 is meeting the Legislature's short-term objectives, we believe there is justification for establishing the program on a permanent basis.

In our view, there are two important benefits to settlement authority. First, it provides a means for resolving complicated tax disputes over uncertain legal issues. Without settlement authority, FTB appeals staff and Board of Equalization members must rule on a disputed tax issue based on the specific conclusion of the audit result. Further, the ruling must be completely in the state's favor or in the taxpayers' favor. Due to the complexity of tax issues, however, an appropriate resolution to a disputed issue may be a ruling that is a compromise between the state's position and that of the taxpayer. Providing settlement authority allows the FTB's appeals staff to negotiate a conclusion to a tax controversy without having to completely resolve complex legal issues.

Settlement Authority Reduces Costs to State and Taxpayers. The second major benefit to settlement authority is that it would reduce the time and resources committed to resolving tax disputes. Currently, the FTB is still resolving tax disputes that were first contested in the 1960s. Through protest, appeals, and court procedures, taxpayers and the state may be in litigation over tax disputes for several years.

We believe that settlement authority would provide taxpayers and the FTB the motivation and ability to resolve tax disputes much sooner, thereby reducing legal and other costs to both parties. There is some uncertainty about the effect that settlement authority would have on state revenues in the short-run. On the one hand, revenue gains would result to the extent that settlements cause taxpayers to pay up sooner than would otherwise occur. On the other hand, revenue losses could occur to the extent that taxpayers become less eager to pursue their legal appeals. This is because they are now required to pay the entire amount in dispute *prior to* appealing an FTB decision to the Board of Equalization. In the longer run, we believe these factors would tend to be offsetting.

Therefore, we recommend that the legislature provide the FTB with the authority to negotiate settlements of tax disputes on a permanent basis.

TAX RELIEF (9100)

The state provides local property tax relief, both as subventions to local governments and as direct payments to eligible taxpayers, through seven different programs. The two largest are the Homeowners' Property Tax Relief (Homeowners' Exemption) and Renters' Tax Relief (Renters' Credit) programs, which now account for 90 percent of the appropriations for tax relief.

The budget proposes to eliminate the Renters' Credit program for both the current *and* budget years. This program provides a "refundable" tax credit to moderate- and low-income Californians who rent their principal place of residence for at least six months of the tax year. Elimination of the program would reduce General Fund expenditures for tax relief by \$395 million in the current year and \$445 million in 1993-94. The budget projects that, if the Renters' Credit is eliminated for tax year 1992, costs in 1992-93 to pay outstanding claims for preceding tax years will be \$30 million. The proposal is contingent on the enactment of legislation which is needed to eliminate the program.

Proposed expenditures for other tax relief programs are not significantly different from current-year costs.

Renters' Credit Proposal for 1992 Requires Prompt Action

We recommend that the Legislature act no later than mid-March on the Governor's proposal to eliminate the Renters' Credit program for tax year 1992.

This proposal differs from the proposal in the 1992-93 Governor's Budget in that last year's budget proposed to eliminate the credit for tax year 1992. The current budget proposes to eliminate the credit for tax years 1992 and 1993. By proposing elimination for tax year 1992, the budget, in effect, is proposing a *retroactive* tax increase for those who qualified for the credit in 1992.

Retroactive Tax Proposal Requires Quick Action. The Governor's proposal to eliminate retroactively the Renters' Credit program has at least two negative short-term consequences. First, as a result of recent action by the Franchise Tax Board, adopting the proposal would impose significant additional tax processing and collection costs (please see Item 1730 for our analysis of this issue). Second, eliminating the credit for tax year 1992 may cause financial difficulties for taxpayers who are already planning on the credit for financial support.

Prompt legislative action on this proposal could alleviate one or both of these consequences. For example, if the Legislature does not want to eliminate the credit for 1992, prompt action could result in significant cost-avoidance by the board. Immediate action also would provide taxpayers who qualify for the claim with timely information regarding the status of the credits. For instance, if the Legislature were to promptly adopt this proposal, these taxpayers would have additional time to attempt to offset the loss of the credits with other resources.

Although it is *legally* feasible to enact legislation eliminating the program any time in 1993, we believe the Legislature should take

immediate action to mitigate short-term problems created by the Governor's proposal. Therefore, we recommend that the Legislature resolve the Renters' Credit issue for 1992 *no later than mid-March*.

Proposal to Eliminate Renters' Credit Falls Short

The administration does not justify why just the Renters' Credit, and not other property tax relief programs, should be targeted for elimination.

The administration justifies its proposal for eliminating the Renters' Credit program "as a part of the administration's plan to bridge the state budgetary funding gap." The administration, however, offers no policy rationale for eliminating this credit, nor does it explore reductions in other tax programs.

Need for Any General Property Tax Relief Programs Has Diminished. Our analysis last year (see 1992-93 *Analysis*, p. VIII-79) indicated that there are good policy reasons to eliminate *both* the Homeowners' and Renters' Tax Relief programs. The Homeowners' Exemption and the predecessor to the Renters' Credit program were established simultaneously to mitigate rapidly rising property taxes in the late 1960s and early 1970s.

As we pointed out, the relative significance of the relief provided to homeowners and renters has diminished over time. In addition, the passage of Proposition 13 in 1978 (1) has provided massive tax relief for both homeowners and renters' and (2) prevents the rapid rise in property taxes that provided the original rationale for establishing these programs.

Governor's Proposal Unlinks the Two Programs. Eliminating the Renters' Credit program would eliminate tax relief benefits for renters while maintaining them for homeowners. The budget offers no policy justification for continuing to provide relief to homeowners while this same relief is taken away from renters. Thus, we believe that a better approach would be to seek the prospective elimination of both programs. This action would free up over \$800 million annually.

An Alternative 1993-94 Solution. Given that implementation of our suggested approach would require a Constitutional Amendment (to repeal the Homeowners' Exemption), it probably could not be implemented until 1994-95. In order to achieve savings in the budget year—while still maintaining some linkage between renters and homeowners, the Legislature could do the following:

- Suspend the renters credit for 1993-94.
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- Reduce the mortgage interest deduction that could be claimed by an amount comparable to the value of the homeowners' exemption.

This approach could contribute significantly to this year's budget solution.

DEPARTMENT OF GENERAL SERVICES (1760)

The Department of General Services (DGS) is responsible for: (1) providing a broad range of support services to operating departments and (2) performing management and oversight activities related to support services. It provides these services primarily through two programs: statewide support and property management services.

The Governor's Budget proposes expenditures of \$563 million from various funds (\$6 million from the General Fund) to support the activities of the DGS in 1993-94. This reflects an increase of \$12 million, or 2 percent, above estimated current-year expenditures. Of the \$563 million, about 33 percent (\$187 million) of the department's costs are funded from direct appropriations, with the balance—67 percent (\$376 million)—being funded from "revenues". These revenues are amounts appropriated to other state entities for payment to the DGS for providing goods and services.

Expenditures for statewide support services are \$336 million in the budget year, representing an increase of \$9 million, or 3 percent, above current-year expenditures. This growth is due mainly to increases to upgrade equipment in the emergency telephone (9-1-1) program (\$3.2 million in local assistance) and replace equipment in the state microwave program (\$1.9 million in state support), an increase in the state's motor vehicle insurance costs (\$2.3 million in state support), and the costs of salaries and benefits resulting from the elimination of the personnel leave program.

Proposed budget-year expenditures for property management services activities are \$211 million, which is \$2.5 million, or 1 percent, above current-year levels. This is primarily due to an increase in capital outlay management activities associated with new capital outlay projects (\$1 million in state support) and the costs of the personnel leave program.

Review of Departmental Performance

Background

Over the years, the Legislature, state agencies, and private vendors have raised concerns about the operation of DGS's support services. In this write-up, we provide an overview of the department's support activities and their costs, summarize the primary concerns raised about the department's operations, and provide options for legislative action to improve the department's operations.

What is the Department's Role? The Legislature created the DGS in 1963 to provide centralized support services to other state agencies. This was done to improve service delivery to state agencies and decrease state costs by taking advantage of specialized techniques and skills, uniform management practices, and economies of scale.

Over the last 30 years, the DGS has provided and overseen a wide variety of support services ranging from building maintenance to the procurement of multimillion dollar computer systems. Generally, these services fall into two broad categories—statewide support services and property management services. Due to cost and workload considerations, however, the DGS delegates the authority for carrying out certain support services to more than 150 other state agencies. Figure 10 summarizes the services for which the department is responsible.

What Is the Cost of the Department's Activities? As we indicated earlier, the Governor's Budget proposes expenditures of \$563 million for the DGS in 1993-94, of which 33 percent (\$187 million) comes from direct appropriations to the DGS and 67 percent (\$376 million) comes from funds appropriated to other state agencies for payment to the DGS. The department bases the prices it charges on the actual cost of providing a specific good or service, taking into consideration its own costs, including salaries, benefits, operating expenses, and equipment.

Department Performance Lacking

During our review, we found that the DGS has never been able to fully achieve the results envisioned by the Legislature—consistently providing high quality services to state agencies in a timely manner and at lower cost. In this section, we discuss why the DGS has not been able to achieve the desired results.

Figure 10

Department of General Services Centralized Services Provided to State Agencies

Service Area	Services Provided
Statewide Support Services:	
Procurement	Central purchasing and materials management
Small and Minority Business	Activities to increase participation of targeted business enterprises in state contracts
Telecommunications	Management and operation of state's telephone system
California State Police	Protection of designated office holders; police/security for state property
Interagency Support	Printing, fleet administration, administrative hearings, mail, other business-related functions, and support to the State Allocation Board, which distributes school facilities funds
Management Services	Personnel, accounting, budgeting, records management, insurance, and other management-related functions
Property Management Services:	
Real Estate and Building	Real estate acquisition and sale, property and construction management, office and parking facility development, energy project development, custodial, and grounds
State Architect	Architectural/engineering consulting, project management and inspection, plan checking, and mitigation of hazardous conditions

High Costs. For state agencies, the cost of doing business with the DGS is often higher than if they individually paid a private vendor. A June 1992 report by the Office of the Auditor General (OAG) on the department's Office of Procurement found that as much as 30 percent of the commodities carried by state stores are sold to state entities at prices ranging from 7 percent to 41 percent higher than those charged by private vendors. Also, information that we reviewed indicates that state agencies often pay more for services such as security or printing than they would pay otherwise. For example, in 1991, the Office of State Printing indicated that it could not meet the price or timing requirements of its clients (please see page 164 in our *Analysis of the 1991-92 Budget Bill*).

Why Are DGS's Costs Higher? We found that there are several reasons for the higher costs:

- **Lack of Competition.** The department's position as the primary supplier of state support services provides no incentive for it to reduce its costs, resulting in higher prices to its state agency customers.
 - **Higher Salaries.** In certain cases, the state pays higher salaries and benefits than the private sector pays employees doing the same type of work. For example, the department's budget request includes proposals to replace contract staff with state staff to comply with the current state policy that limits the use of outside contractors. For certain classifications, the cost of the state staff will be more than 25 percent higher than for contract staff, primarily as a result of state employee benefit costs.
 - **State-Required Goals.** State requirements intended to fulfill certain social policy goals (such as increasing the amount of recycled goods purchased by the state or increasing the participation of small businesses in state contracts) increase costs in two key ways: (1) by creating accepted price differentials and bid criteria which result in the state paying higher prices for certain goods and services and (2) by increasing the workload of state staff. According to the DGS, the 5 percent price preference for small business results in about \$450,000 in additional annual costs to the state. The economic benefit of these requirements to the California economy is unclear.
 - **Inadequate Planning and Analysis.** Inadequate business planning and financial analysis by the DGS results in the state taking on activities and entering into transactions that may not be cost-effective. For example, in 1990 we found that the DGS did not complete a feasibility study report which would have evaluated the potential costs and savings of the \$100 million California Network System (CALNET) and competing alternatives (please see page 167 in our *Analysis of the 1990-91 Budget Bill*).
 - **Inefficiencies.** Operating inefficiencies, such as outmoded manual processes, increase the number of DGS staff, office space, and other resources needed to deliver DGS services. For instance, the June 1992 OAG report found that the DGS did not have adequate systems in place to manage the processing of purchase estimates or establish processing time standards for the various phases of the procurement process.
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- **Complexities.** Complex state requirements and lengthy processes increase vendor costs particularly in areas such as procurement. Vendors ultimately pass these costs back to the state, either partially or fully, in the form of higher prices. According to recent research, a vendor's cost of bidding can exceed \$1 million for a complex project due to the costs of responding to initial proposals and amendments, various regulatory requirements, and the time associated with bid protests.

Poor Service Quality. The department's performance often falls short in the important area of service quality. For example, the Auditor General reported that in 1991, state supply stores took an average of 26 days to process a state agency supply order. By comparison, a state agency could order an item from a private vendor in many cases and have it delivered the next day. We also have identified other examples of poor service quality, including unavailability of rental vehicles and inadequate capacity to meet state agency printing needs.

What Accounts for Poor Service Quality? As with high costs, we found that lack of competition, state-required goals, and inefficiencies and complexities prevent the state from achieving its service delivery goals. In addition, we found several other reasons for poor service quality.

- **Budget Reductions.** Recent budget reductions have reduced resources in all areas of the DGS resulting in less ability to provide services. For example, the department has reduced commodity purchases below the projected level of client demand.
 - **Specification Weaknesses.** The service provided is not what the client agency needed or requested. In procurement, this can result from bid specifications not adequately reflecting the client's needs. For example, it is not uncommon for requests for proposals (RFPs) for the purchase of goods and services to require several amendments.
 - **Lack of Performance Measurement.** Inadequate cost accounting and monitoring systems, and the lack of performance standards makes it impossible for the DGS to adequately manage its workload. As indicated previously, the OAG reported in 1992 that the DGS did not have adequate systems to establish time standards for the various phases of the procurement process.
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Can the State Improve the Delivery of Support Services to State Agencies?

In the preceding section, we discussed why the DGS has not been able to provide consistently high quality services in a timely manner and at lower cost. In this section, we discuss the questions that we believe the Legislature should consider in making decisions about how to improve the delivery of state support services.

Which Support Services Are Needed? Currently, it is not clear which of the support services now provided to state agencies are most important to their operations. Also, it is not clear, which, if any, *additional* support services are needed by state agencies. This information is necessary in order to identify those support services which are now critical to the state's ongoing operations.

What is Needed to Provide Consistently High Quality Services in a Timely Manner and at Lower Cost? Research indicates that several factors contribute to improving service delivery and decreasing costs: (1) the organization's resources must be well matched with the service provided, (2) systems must be in place to support service delivery, and measure service activities and quality, and (3) competition must exist to create incentives for improving service delivery and decreasing costs. These factors, which are discussed below, are critical for assessing which services an organization is most capable of providing.

Matching Resources and Services. In matching resources and services, the Legislature must consider the following:

- ***Capital Requirements.*** The organization must have the necessary equipment to do its job. This is particularly true in services areas that rely heavily on computer support or other rapidly changing technology, such as telecommunications. The state's current budget situation severely limits its ability to invest large financial resources for new or replacement equipment. In addition, the state's current budget and procurement processes make it difficult for a department to plan for large purchases or receive them in a timely manner.
 - ***Knowledge and Skills.*** The organization must have staff with the necessary knowledge and skills. This is particularly true with information technology where current experience in systems analysis, design, and implementation is critical. Currently, it is not uncommon in the DGS and other state agencies for staff without such experience to have responsibility for planning complex and expensive computer systems. Without this type of support, the organization cannot adequately make decisions
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about how best to utilize information technology. In this area, the wrong decisions can result in unnecessary costs to the state in the form of expensive hardware, software, or processing time. Civil service system rules frequently restrict the state's ability to hire the right person at the right time. In addition, budget reductions have virtually eliminated training funds in many state departments. Without ongoing training, it is extremely difficult for staff to remain current in their fields.

- **Planning and Analysis.** The organization must have the ability to complete the necessary planning and analysis. Without adequate planning and analysis, the state is unable to develop cost-effective processes and procedures for carrying out its services activities. In addition, it is unable to fully assess the financial soundness of its transactions. This requires the appropriate staff expertise and support, and adequate time for planning and analysis activities. As indicated previously, the OAG found that the state began the development of the multimillion dollar CALNET system without the appropriate financial analysis.
- **Responsiveness, Reliability, and Access.** The organization must have the ability to work closely with clients to ensure that their needs are met, and provide consistent and accurate service at the time it is needed by clients. These service factors hinge upon having the appropriate organizational structures, processes and procedures in place, and the flexibility to move staff in response to service needs. The state's budgeting and personnel rules now limit an organization's ability to move staff easily or quickly from one area to another to meet changing service demands.

Systems. The appropriate systems must be in place to support service delivery and measure service activities and quality. In developing systems, the Legislature should consider the following:

- **Performance Measurement.** Performance measurement and cost accounting systems must be in place to define appropriate service levels, monitor quality, and assess the amount of resources needed to carry out a service activity. These types of systems hinge upon having adequate computer support and cost accounting expertise.
 - **Separation of Service Delivery and Control Functions.** The service delivery function must be separate from the service oversight function because there is an inherent conflict between the two functions. For example, the DGS is now responsible for
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both developing procurement/contracting policies and purchasing goods and services.

- ***Focus on Results.*** State requirements, processes, and procedures must focus on *results* rather than inputs. Currently, the state's support services are guided by a complex set of state laws, regulations, processes, and procedures.

Competition. Research indicates that competition is one of the biggest factors in improving service quality and decreasing costs. Additionally, it shows that many state and local governments have successfully adopted three primary forms of competition—public versus public, public versus private, and private versus private. In public versus public competition, state agencies would compete among themselves. For example, both the DGS and the Prison Industry Authority could offer printing services to state agencies. In public versus private competition, one or more state agencies would compete with private companies. For example, the State Controller's Office could compete against private accounting firms for certain types of reviews. With respect to private versus private competition, private firms would continue to bid for state contracts as they do now.

Should the State Continue to Achieve Social Policy Goals Through Support Services Programs? In certain cases, the state has attempted to achieve social policy goals through DGS's support services, such as increasing the purchasing of recycled goods or increasing the participation of women, minorities, and disabled veterans in state contracts. Such programs tend to increase the costs of services provision. The Legislature may need to consider whether there are alternative ways of achieving the desired social goals that may be achieved more directly, such as providing seed money for particular types of activities.

Fundamental Rethinking of DGS Support Services Needed

We recommend that the Legislature undertake a fundamental rethinking of how the department provides support services to state agencies. In order to do this, we recommend that the Legislature take steps to introduce competition into the state's current system of support services and authorize a business audit of the support services now provided by the department.

To the department's credit, it has, over the years, adopted many approaches to improve its operations. These include total quality management teams, customer advisory councils, and surveys of client agencies. We believe that these efforts have improved the department's

operations. However, our analysis of the Department of General Services indicates that, without a fundamental rethinking of the state's role in the delivery of support services, the department and the state can make only marginal improvements in the delivery of support services.

What Is Meant by a Fundamental Rethinking? When we refer to a fundamental rethinking, we mean reconsidering which centralized support services are needed by state agencies, how the state can best provide such services to agencies, and how social policy best fits within the state's service delivery system. For example, such a rethinking could involve changing statutes governing how the state now provides and obtains services, introducing competition into the system, or discontinuing services for which the state cannot maintain high quality or reasonable cost. The experience of other states and private businesses should be utilized. For example, some jurisdictions have found that the use of model procurement contracts has resulted in better service quality and savings. Also, private firms have found that contracting out fleet administration is cost effective.

Why Is a Fundamental Rethinking Needed? In our view, a fundamental rethinking of the state's service delivery system is needed for three key reasons. First, while the *service delivery environment* has changed dramatically over the years, the state's *service delivery system* has essentially remained the same. When the Department of General Services was established 30 years ago, the delivery of goods and services to state agencies was much less complex than it is now. Today, for example, there are many more state agencies purchasing a very wide variety of goods and services annually; advances in technology have made goods and services more complex; and the demand for products and services changes rapidly as new ones are introduced.

Second, many of the problems that we discussed above, such as a lack of competition, cannot be remedied without making some basic changes to the current support services delivery system.

Third, as we point out, there are questions about the state's ability to provide, over the long-run, high quality services in a timely manner and at lower cost.

What Should the Legislature Do? We believe that there are two important steps that the Legislature can take now to improve the delivery of state support services. The first step is introducing competition into the state's service delivery system. It could be introduced by allowing greater flexibility to state agencies to purchase goods and services directly from private vendors and/or by allowing other state agencies to compete with the DGS. Both of these actions

would require changes to current laws governing the state's procurement and contracting activities. This could be accomplished on a pilot basis in a small number of departments.

The second step is to authorize a *business audit* of the services now provided by the department. In general, the purpose of this audit would be to identify which support services are now needed by state agencies and to assess the strengths and weaknesses of the services currently provided by the DGS. More specifically, the business audit would assess the department's ability to deliver services relative to common business indicators, such as systems and technology, technical skills, and service quality. This information would then be compared with current requirements for providing high quality services at lower cost over the long-term. With this information, the Legislature could assess which services the state is most capable of providing and how the state can best provide the services to agencies. Additionally, this information could be used to identify the tradeoffs between social policy goals and the quality and costs of services.

In our view, an audit of this type should be performed by an outside organization that has expertise in large-scale service delivery and is knowledgeable about the state's operations. In addition, we believe that it is critical for this group to communicate with key government staff, including state agency customer and service staff, vendors, and employee unions to ensure that the auditing/consulting group's recommendations consider the state's entire business environment.

Property Management Services Reorganization

The department is currently considering a reorganization of its property management service functions. Specifically, the department is attempting to put in place an organizational structure that will (1) put more emphasis on strategic planning for the state's real estate needs and (2) integrate strategic planning with the state's leasing and capital outlay activities. As contemplated, this new structure would provide more accountability and coordination of property management functions. Based on our discussions with department management, we believe that the changes being considered would be a major improvement in the department's ability to provide more efficient and cost effective service to other state agencies.

Even if these improvements are realized, the DGS's property management functions, like its statewide support services, will still be subject to constraints that limit the department's ability to provide the most economical service. As discussed earlier, these constraints include potential higher costs due to restrictions on competition with the private

sector, advancing certain social goals through state contracting, and having to comply with numerous state rules and regulations. Therefore, any comprehensive examination of these issues should assess the potential impact on property management.

Other Departmental Issues

9-1-1 Surcharge Rate Should Be Reduced

We recommend that the department and Board of Equalization decrease the current surcharge rate to better reflect 9-1-1 system expenditures, and /or earmark funds, in excess of a prudent reserve, for 9-1-1 expenditures, such as capital equipment.

The Emergency Telephone (9-1-1) System is a network of local communication centers designed to provide immediate access to emergency services, such as fire, police, and emergency medical services. The program is administered by the department and is funded by a surcharge on all telephone bills in California. The surcharge is currently set at 0.69 percent of each bill. The department uses the revenue generated by the surcharge to reimburse local governments and telephone utilities for the system's costs.

The budget proposes two transfers of moneys from the State Emergency Telephone Number Account (9-1-1 Account) to the General Fund—\$6.5 million in 1992-93 and \$15 million in 1993-94.

The proposed transfers from the 9-1-1 Account to the General Fund in the current year and budget year raise questions about the high level of reserves expected to accrue in the State Emergency Telephone Number Account. Current law provides that the surcharge rate, which is set by the BOE, shall be based on the system's expenditures. However, at the current surcharge rate of 0.69 percent, the department estimates that revenues will exceed expenditures by an estimated \$20.9 million in 1992-93 and \$19.7 million in 1993-94, or by about 30 percent each year. In our view, accumulating this level of fund reserves appears inconsistent with existing law which requires that the surcharge be based on the system's expenditures. In addition, because the surcharge generates more revenues than required to meet projected expenditures, the current rate constitutes a "hidden" tax on the state's consumers.

Given the above, we recommend that the department and BOE decrease the current surcharge rate to better reflect 9-1-1 system expenditures and/or earmark funds, in excess of a prudent reserve, for system 9-1-1 expenditures, such as capital equipment.

Additional Information Needed on 9-1-1 Equipment Purchases

We withhold recommendation on \$3.2 million requested to purchases 9-1-1 replacement equipment, pending receipt and review of detailed cost information on the equipment.

The budget proposes \$3.2 million from the 9-1-1 Account to replace obsolete system equipment. According to the DGS, this equipment, which was purchased prior to 1986, is no longer compatible with more current technology.

At the time this analysis was prepared, the department had not provided the Legislature with a list of the equipment to be purchased and their individual costs. Without this information, the Legislature is unable to fully assess the request. The department indicates that this information is forthcoming. As a result, we withhold recommendation on this proposal, pending receipt and review of the detailed cost information.

Inadequate CALNET Fraud Prevention Proposal

We recommend that the department provide a revised CALNET fraud prevention proposal to the budget committees, prior to budget hearings, that considers alternatives for carrying out fraud monitoring activities; necessary planning, development and implementation activities; and necessary staff and computer support.

The California Network System (CALNET) is a state-owned telecommunications system that connects state and local agencies statewide.

Budget Proposal. The budget proposes to initiate a fraud monitoring function for CALNET in 1993-94 that the department estimates will result in an annual \$240,000 decrease in CALNET losses due to fraud (primarily, the fraudulent use of state telephone credit cards). As proposed, this \$240,000 decrease in CALNET fraud losses would be used to fund two three-year limited-term positions (\$124,000 in 1993-94) to carry out fraud monitoring activities. Additionally, CALNET spending authority would be reduced by the remaining \$116,000.

Concerns With the Fraud Prevention Proposal. Our review indicates that the proposal is based on several questionable assumptions. First, the proposal assumes \$240,000 annually in fraud avoidance savings beginning in 1993-94. Our review indicates that it is more likely that little, if any, fraud avoidance cost savings will occur in 1993-94. This is because the department's workload analysis indicates that essentially no time has been allocated to actually develop or test fraud monitoring

processes. Rather, the department's workload analysis suggests that staff will be able to almost immediately begin identifying system fraud.

Second, the budget assumes that no special hardware, software, or computer support will be needed to carry out this function. However, fraud prevention and detection is a constantly changing area that relies heavily on computer technology. Such funding may be necessary in order to implement this fraud prevention proposal.

Proposal Needs Additional Work. While we believe that CALNET fraud monitoring activities are integral to the system's operation and integrity and that it is the state's best financial interest to undertake such activities as soon as possible, we also believe that this proposal as presently configured is unlikely to meet the state's needs or generate the projected savings. Thus, we recommend that the department provide a revised fraud detection plan to the budget committees prior to budget hearings. Specifically, the proposal should consider alternatives for carrying out fraud monitoring activities; necessary planning, development, and implementation activities; and necessary staff and computer support.

OFFICE OF EMERGENCY SERVICES (0690)

The Office of Emergency Services (OES) coordinates emergency activities necessary to save lives and reduce losses from disasters. The OES further acts as the state's conduit for federal assistance related to recovery from disasters.

The amount proposed for direct support of the OES in 1993-94 totals \$32.7 million, including \$14.8 million from the General Fund, \$9.1 million from federal funds, and the remainder (\$8.9 million) from various other funds and reimbursements. This is essentially the same amount as in the current year.

In addition to direct support costs, the budget includes \$174 million for local assistance to pay claims from previous disasters. This is \$28.5 million, or 14 percent less than estimated current-year expenditures for local assistance, primarily due to a decrease in anticipated disaster assistance claims. The amount proposed for local assistance in the budget year includes \$135 million from federal funds, \$19.1 million from the General Fund, \$19 million from disaster assistance accounts, and \$1.6 million from the Nuclear Planning Assessment Special Fund.

Uncertainty About Costs of Past Disasters

We recommend that the OES report to the Legislature, prior to budget hearings, on its estimates of disaster assistance costs for past disasters.

In recent years, the General Fund and the Disaster Relief Fund (DRF) have been the primary sources for state disaster assistance funds. The DRF was established as a source of revenue for earthquake response and recovery activities following the Loma Prieta earthquake in October 1989. The source of monies for this fund was a time-limited increase in the state sales tax. Based on current estimates, all of the DRF's resources will be depleted in 1993-94.

Budget Proposal. The budget proposes two General Fund appropriations for disaster assistance claims—\$3 million in the current year and \$19 million in the budget year. According to the OES, these appropriations are needed to pay anticipated claims from *previous* disasters that occurred as long ago as the early 1980s.

Inadequate Justification. We have two concerns with the budget request. First, the OES was unable to explain the processes it uses for tracking disaster assistance claims or estimating the state operations or local assistance costs for disasters that have already occurred. Second, information that we reviewed from local agencies indicates that OES expenditure estimates for outstanding claims may not adequately reflect adjustments to the initial disaster estimates that are prepared soon after a disaster occurs. Such adjustments can substantially change the state's expenditures for disaster assistance in a specific fiscal year.

Accordingly, we recommend that the OES report to the Legislature, prior to budget hearings, on its estimates of disaster assistance costs for past disasters. Specifically, this report should explain: (1) how disaster assistance claims are tracked, (2) how the OES determines the fiscal years in which claims will be paid, (3) how the OES tracks claim adjustments, and (4) the methodology for preparing its estimates of the state operations and local assistance costs for past disasters. In addition, the report should include revised expenditure estimates (by fiscal year, disaster, and fund) of the total amount of outstanding claims for past disasters.

Certain Budget-Year Costs Not Estimated

We recommend that the OES submit a report to the Legislature, prior to budget hearings, that: (1) includes projections of the state's disaster assistance costs for the budget year and (2) specifies which budgeted activities the OES proposes not to carry out in the event that staff are reassigned to disaster response and recovery activities.

In the previous issue, we discussed the costs of past disasters, which are included in the OES's budget request. In this section, we discuss the costs of disasters that are not currently estimated by the OES.

Background. The OES develops its budget by estimating: (1) the cost of claims for all but the most recent disasters and (2) the cost of the office's ongoing workload. The budget request *excludes* estimates of: (1) other claims that will be paid in the budget year and (2) the costs the OES will incur for nonbudgeted emergency response and recovery activities. To the extent that additional disaster funding is needed beyond that included in the budget, existing law authorizes the Director of Finance to transfer monies, with legislative notification (but not approval), from the General Fund to the appropriate disaster assistance accounts to cover disaster-related costs of state and local agencies.

Excluding Estimate of Costs from Budget Understates the State's Financial Liabilities. By excluding estimates of the additional disaster costs, the budget does not account for costs that the state will incur in the budget year. For example, the 1992 Budget Act for the 1992-93 fiscal year included no estimate of the cost of disasters that occurred between October 1991 and July 1992 for which the state now expects to pay about \$18 million in 1992-93. Likewise, the budget proposed for 1993-94 does not include an estimate of state costs for recent disasters (particularly the recent winter storms) even though they will result in additional costs, potentially in the tens of millions of dollars.

The OES's current budgeting process also understates the office's likely workload. According to the OES, it frequently discontinues its *budgeted* activities to carry out *nonbudgeted* disaster response and recovery activities. For example, during the Humboldt earthquake in 1992, staff were redirected from activities in the plans and preparedness program to respond to this disaster.

Additional Information Needed. Although we realize that it is not possible to predict a specific disaster, historical experience indicates that on average several disasters will occur annually in California. Consequently, we believe that it is important for *baseline* planning estimates of disaster costs to be developed. Such estimates will assist the Legislature in assessing the state's future expenditure and reserve

requirements. Our preliminary review indicates that these estimates should reflect between \$10 and \$20 million dollars annually in state support and local assistance costs for potential disasters.

In addition, because the OES has not advised the Legislature which activities it plans to delay in order to carry out disaster response and recovery activities, the Legislature has no way of assessing: (1) the office's nine budget proposals totaling \$23 million (excluding the proposal to fund the disaster assistance claims discussed above), or (2) whether its priorities are being carried out. Moreover, the office's budget proposals raise questions about the OES's ability to take on new initiatives when a claims backlog exists and the development of the Operational Area Satellite Information System has been delayed due to reassignment of staff during the year to response and recovery activities.

Currently, the OES is setting its own priorities without any legislative oversight. In our view, before the Legislature can take action on the office's budget, the OES must first advise the Legislature on its plans for carrying out currently budgeted activities and which budgeted activities it proposes to give up when staff are reassigned to response and recovery activities.

Given the above, we recommend that the OES submit a report to the Legislature, prior to budget hearings that: (1) includes projections of the state's disaster assistance costs for the budget year and (2) specifies which budgeted activities the OES proposes not to carry out in the event that staff are reassigned to disaster response and recovery activities.

Legislative Oversight Needed

We recommend that the OES report to the Legislature during budget hearings on the establishment of an internal mechanism for tracking disaster-related costs.

Previously, we discussed the need of the OES: (1) to improve the accuracy of its cost estimates for past disasters and (2) to estimate the recent and future costs of disasters for planning purposes. Additionally, we indicated that existing law authorizes the Director of Finance to transfer monies, with legislative notification, from the General Fund to specified disaster-assistance accounts in order to cover additional disaster costs.

Periodic Reporting Needed on Disaster Costs. Even with these measures, additional information is needed to track the state's disaster-related costs on an ongoing basis for purposes of legislative oversight.

This is because the additional costs of new disasters and unexpected increases in the amounts of claims paid during a fiscal year are not included in the budget and represent claims against the state's General Fund reserves. Although we have requested the information needed to track the OES's revenues and expenditures numerous times, the OES has been unable to provide this information. In our view, the OES should have an internal mechanism for maintaining this basic financial information, and this information should be readily available to the Legislature for oversight purposes. This is all the more critical because, as indicated above, OES staff are often out of the office and not available to respond to legislative inquiries. Therefore, we recommend that the OES report to the Legislature during budget hearings on the establishment of an internal mechanism that includes, but is not limited to, expenditures for support and local assistance for disasters, revenues (including federal funds) to pay for disaster assistance costs, and transfers to the various disaster assistance accounts.

BOARD OF CONTROL (8700)

The Board of Control (BOC) oversees diverse activities including state regulation and management of claims under the following programs: Citizen Indemnification (also known as Victims of Crime), Civil Claims Against the State, and Hazardous Substance Claims. The Victims of Crime (VOC) Program accounts for about 99 percent of board's total expenditures.

The budget proposes expenditures of \$90.3 million in 1993-94, including \$840,000 from the General Fund. This is about \$4 million, or about 5 percent, more than estimated current-year expenditures. This increase is primarily due to a projected increase in the cost of claims in the VOC Program.

Significant Funding Shortfalls Likely in Victims of Crime Program

We recommend the board report during budget hearings on the status of the funding shortfalls in the VOC Program and the program changes needed to address the shortfalls.

Background. The VOC Program compensates those persons who (1) are injured or suffer financial hardship as a result of crimes of violence, (2) suffer financial hardship because a family member was injured as a result of crimes of violence, or (3) sustain damage or injury while performing acts that benefit the public. About 80 percent of the

cost of claims is for noninsured medical and mental health expenses. The remaining costs are for wage loss, funeral expenses, and rehabilitation expenses.

Budget Proposal. The budget proposes total expenditures of \$89.4 million for support of the VOC Program in 1993-94. Most of this amount comes from the Restitution Fund (\$73.6 million) and the Federal Trust Fund (\$15.8 million). This is \$3.9 million, or about 5 percent, more than current-year expenditures. Expenditures for this program include payment of victims' claims (\$64.8 million) and administration of the program (\$24.6 million). Funds for the payment of claims are continuously appropriated to the board, but administrative costs of the program are included in the annual budget act.

Funding Sources. The Restitution Fund receives its revenues from restitution fines and penalty assessments. For 1993-94, the Governor's Budget estimates revenue from restitution fines to be \$23.2 million. These fines are imposed on convicted felons. Revenue from penalty assessments is estimated to be \$50.8 million in 1993-94. Penalty assessments are imposed on persons who violate criminal or traffic laws.

Steps Taken to Address Funding Shortfalls. Last year, we reported that the board was projecting a significant funding shortfall in the VOC Program for 1991-92 and 1992-93, because claims were exceeding revenues for the program. In addition, the board was reviewing revenue enhancement and cost containment options for addressing the shortfalls (see page VIII-53 of the *Analysis of the 1992-93 Budget Bill*). Several actions were taken last year to address the shortfall.

First, in January 1992, the board adopted the worker's compensation fee schedule as the maximum rate of reimbursement. As a result, this change lowered the total reimbursements for claims.

Second, in September 1992, the Legislature enacted Ch 682/92 (SB 1444, Presley). The measure included a number of provisions designed to address the shortfall, most of which provided for additional revenue to the Restitution Fund. The provisions included the following:

- Increased minimum restitution fines for felony offenses from \$100 to \$200.
 - Raised from 20 percent to 50 percent the amount of earnings of prison inmates and Youth Authority wards that can be withheld for outstanding restitutions fines.
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- Provided incentives for counties to collect additional restitution fines by allowing them to receive 10 percent of the fines collected.
- Authorized the board, for 1992-93 only, to delay payments up to six months in the case of a shortfall. Also, provided that victims in the greatest need shall receive payments of claims at the earliest date.

In addition, the 1992 Budget Act earmarked up to \$150,000 for a contract with the Office of the Auditor General (OAG) for a management review of the program to identify administrative efficiencies and legislative changes to reduce the cost of the program. The OAG was unable to begin this review prior to closure of the office.

No Funding Shortfall in 1991-92. Current information shows that for 1991-92 the VOC Program ended the year with a surplus of about \$6.2 million, instead of a \$21.5 million shortfall, as originally estimated. This was primarily due to: (1) receipt of a \$19.5 million federal grant in 1991-92 instead of in 1992-93, and (2) actual payments for claims being about \$8 million less than the board's initial estimates. Based on our review, the decrease in claims is primarily attributable to limitations negotiated on hospital reimbursements (adopted in 1991), adoption of the worker's compensation fee schedule, and a delay in payment of claims due to monthly cash fluctuations in the Restitution Fund.

Funding Shortfalls for the Current and Budget Years. In this section, we review the potential funding shortfalls for the program. We base our analysis on expenditure estimates provided by the board. The Governor's Budget uses *lower* expenditure estimates for the current and budget years. It shows no shortfalls.

The board estimates that the shortfall for the current year will be \$1.7 million, instead of the \$50 million initially estimated. The shortfall is less than expected primarily due to: (1) carry over of the \$6 million prior-year surplus, (2) an 18 percent increase in the Department of Finance's (DOF) estimates of restitution fines and penalty assessments, and (3) a \$34 million decrease in expected payments for claims from \$107 million to \$74 million. At the time this analysis was prepared, it was not possible to determine the accuracy of the DOF's revenue estimates because it is too early to assess the impact of Ch 682/92 on revenues. However, we find that the board's estimate of current-year expenditures, which is based on seven months of actual expenditures, is reasonable.

The board is projecting a shortfall in 1993-94 of \$18.4 million, based on a revenue projection of \$87.6 million and program costs of

\$106 million (\$80.8 million for claims and \$24.6 million for administration). The revenue projection primarily reflects a 17 percent increase in restitution fines and penalty assessments. As indicated above, at this time, it is not possible to assess these estimates because of the uncertainty of the impact of Ch 682/92 on these revenues. The estimated increase in expenditures primarily reflects a 10 percent increase in the cost of claims. Based on the available historical data, this increase appears plausible but by no means certain.

Plans to Address the Shortfall. In the current year, the board plans to address the \$1.7 million projected shortfall by delaying payment of claims until 1993-94. This action would have the effect of eliminating the projected shortfall in the current year but increasing the budget-year shortfall by \$1.7 million to about \$20.1 million.

To address the projected budget-year shortfall, the board is again reviewing cost containment options that would limit program benefits. We outlined a number of options last year for addressing the program's shortfall; we believe these options are still relevant this year (see page VIII-55 of the *Analysis of the 1992-93 Budget Bill*).

Analyst's Recommendation. Due to the major program changes that have been adopted in the past year, the magnitude of the projected shortfall in the budget year, and the major changes to the program that will again have to be considered by the board and the Legislature in the near future, we recommend that the board report during budget hearings on the status of the VOC Program. Specifically, the board should provide (1) a monthly comparison for the current year and the budget year of projected and actual claims filed, revenues and expenditures, (2) an update on the funding shortfall for the current and budget years, (3) the revenue enhancement and cost containment changes being considered to reduce or eliminate the funding shortfall, and (4) the impact of these changes on victims of crime and on other special fund programs.

MILITARY DEPARTMENT (8940)

In general, the functions of the Military Department are to protect the lives and property of the people of California during periods of natural disaster and civil disturbances and provide military units ready for federal mobilization.

The budget proposes the expenditure of \$462 million for support of the department in 1993-94. This is an increase of approximately \$3.5 million, or less than 1 percent, above current-year expenditures.

The budget includes \$444 million in federal funds for expenditure in 1993-94. Of this amount, only \$25.6 million is appropriated through the Budget Bill. The remainder (\$419 million) is administered directly by the federal government. The amount proposed from the General Fund—\$16.6 million—is essentially the same as the current year amount.

Budget Proposes to Reestablish Support for the State Military Reserve

We recommend that the Legislature deny the department's request to redirect \$189,000 from the temporary emergency shelter program to reestablish the state support for the State Military Reserve because (1) the proposal is inconsistent with previous legislative action and (2) the department has submitted no justification for the proposal.

The budget proposes to redirect \$189,000 in General Fund monies from the department's homeless shelter program to reestablish two positions in support of the State Military Reserve (SMR) in the budget year. Last year, the Legislature deleted funding for the SMR and transferred the funding to the shelter program.

State Military Reserve. The SMR was established in the 1930s to provide the state an organized and disciplined state military force for state security or recovery operations in the event of federal mobilization of the National Guard. Since it was first organized, the SMR has been fully mobilized twice; it was activated for both World War II and the United Nations police action in Korea. Since then, the SMR has mobilized on a limited basis in support of state emergencies.

Prior to the deletion of state funding last year, the state support for the SMR consisted of two positions in headquarters that were primarily responsible for the coordination of the recruitment of qualified individuals as a stand-by military reserve unit.

Temporary Emergency Shelter Program. The National Guard armories provide homeless citizens with temporary emergency shelter during life threatening weather conditions for the months of November through March. According to the department, these armories provide over 200,000 shelter nights of support in 16 counties throughout the state. In previous years, armories could only be used as shelters when the temperature was projected to be 40 degrees or below, or 50 degrees or less with the possibility of precipitation. From November 15, 1991 through February 15, 1992, the department temporarily suspended the weather restrictions of the program as an experimental expansion of the program.

Last year, the Legislature adopted Budget Bill language that authorized the department to operate the shelters without the temperature restrictions in 1992-93 in order to maximize assistance for homeless persons. To fund the expansion of the program, the Legislature redirected \$189,000 in General Fund monies from SMR to support the shelter program. The Governor, however, vetoed the Budget Bill language.

The budget proposes to reduce funding for the homeless shelter by \$189,000 and redirect the funds back to the SMR in order to once again re-establish state support for this program in the budget year.

At the time this *Analysis* was prepared, the department had not provided *any* documentation to support the request.

Analyst's Recommendation. Given that (1) the proposal is inconsistent with the Legislature's action last year and (2) the department has provided the Legislature with no justification for the proposal, we recommend that the request be denied.

CONTROL SECTION 3.90— UNALLOCATED REDUCTIONS

We recommend deletion of proposed budget Control Section 3.90 because it would give the Administration blanket authority to make budget reductions without the opportunity for meaningful legislative oversight. Instead, we recommend that the Legislature request the Department of Finance to present a specific list of proposed reductions.

Proposed Control Section 3.90 authorizes the Director of Finance to make reductions totaling up to \$150 million from any General Fund appropriations in the 1993 Budget Act. The only provision for legislative oversight in the implementation of Section 3.90 is a requirement that the Director provide a list of the reductions to the Chair of the Joint Legislative Budget Committee within 30 days *after* making the reductions.

In the current year, Section 3.90 of the 1992 Budget Act authorizes the Director to make General Fund reductions totaling up to \$65 million in General Fund appropriations, but specifically exempts 25 organizations from these reductions. On September 28, 1992, the Director notified the Legislature that he had used this authority to make reductions totaling \$59.5 million, and he provided a list of the reductions.

From the Legislature's perspective, Control Section 3.90 amounts to an unallocated reduction of \$150 million that could affect any General Fund budget item with no provision for meaningful legislative control or oversight. We recommend that the Legislature deny this blanket authority, and, instead, request the Administration to present a specific list of proposed budget reductions for the Legislature's consideration. We note that the Director of Finance requested agency secretaries to provide lists of potential reductions to the Department of Finance by February 19, 1993. Thus, the Administration should be in a position to present specific proposals for reductions during budget hearings.

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Crosscutting Issues

The State's Retirement Systems

1. **Retirement-Related State Costs Approach \$1.7 Billion.** 11
The budget includes total state expenditures approaching \$1.7 billion, including almost \$1.3 billion from the General Fund, for various costs associated with public employee retirement.
2. **Proposition 162.** Proposition 162—the California Pension Protection Act of 1992—may fundamentally alter relationships between retirement boards (at both state and local levels) and respective executive and legislative branches of government. The act raises important implementation issues, which we discuss in more detail in our analysis of the PERS budget (Item 1900 of this Analysis.) 12

Tax Agency Consolidation

3. **Proposed Consolidation of Tax Administration Activities Offers Long-Run Benefits.** 14
The proposed creation of a Department of Revenue to carry out state tax administration activities represents a real opportunity to improve services and generate long-run cost savings. The Legislature should proceed with legislation to establish the Department of Revenue, and begin to work out the details involved in consolidating the tax administration activities of the two existing tax agencies.

Contributions to the Judges' Retirement Fund

4. **Future Benefits Are Completely Unfunded.** The payments made by current members of the Judges' Retirement System and their employers go directly to pay benefits to current retirees, providing nothing for the retirement of current judges. Moreover, these contributions are not even adequate to cover the benefit payments to current retirees, forcing the General Fund to make up the difference. 18
5. **General Fund Subsidy Continues to Grow.** To honor 1993-94 benefit payments to current retirees, the budget includes a subsidy of \$52.5 million from the General Fund—an increase of \$6.5 million over the current-year subsidy. 18
6. **Changes to the Existing System.** We recommend enactment of legislation that reduces the General Fund cost of the existing judges' retirement system, including legislation to increase member contributions for a potential \$4.7 million General Fund savings in 1993-94. The Legislature also should consider options of (a) reducing benefits and (b) increasing the amount of court filing fees transferred to the JRF. Such additional steps could save the General Fund as much as \$10 million in 1993-94 and could produce major additional savings thereafter. 21
7. **Create a New System for New Judges.** We recommend enactment of legislation to create a less costly retirement benefit plan for new judges that will be fully funded on an actuarially sound basis. 22

Public Employees' Retirement System

8. **PERS Budget Display Is Informational Only.** The Budget Bill does not include items of appropriation for the PERS (other than one appropriation for health benefits administration) because the PERS contends that Proposition 162 grants it authority to spend funds without appropriations by the Legislature. 24

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9. Legislation Needed to Clarify PERS Role in State Government. We recommend the enactment of legislation clarifying the extent to which public retirement systems, including the PERS, still are subject to state laws and the State Constitution.	27
10. Legislature Should Continue an Oversight Role Through the Budget Process. We recommend that the Legislature enact legislation to (a) rescind the continuous appropriations of the state's employer contributions to the PERS and (b) require that the employer contribution amounts be reviewed and approved through the annual Budget Act.	27
11. Pension Abuse Audits—PERS Action Goes Against Intent of Legislature. We recommend that the PERS report prior to budget hearings on the basis for its reversal of the Legislature's direction in the 1992 Budget Act to bill public agencies for the costs of audits of those agencies.	28
12. Spending on Outside Investment Advisors Nearly Equals All Other Spending on PERS Operations. We recommend that the PERS report to the fiscal committees prior to budget hearings on its spending on outside investment advisors, including steps the PERS will take to ensure that in the future these expenditures are cost-beneficial, especially in comparison with use of in-house advisors.	29
13. Increase PERS Accountability to Employee Members. We recommend that the Legislature enact legislation to require periodic adjustment of employee contribution rates, as one means to increase PERS management accountability to system beneficiaries and to have an equitable share in cost changes between employees and the state.	33
14. Transfer of Health Benefits Administration. We withhold recommendation on the Governor's proposal to transfer administration of employee health benefits from the PERS to the Department of Personnel Administration (DPA), pending receipt of a detailed proposal.	35

PERS Employer Contribution Rates

15. **The PERS has not Determined Rates for 1993-94.** We withhold recommendation on employer contribution rates for retirement benefits pending final determination of the actual rates to be applied in the budget year and receipt and review of information regarding the basis for the actuarial assumptions underlying the determined rates. 36

State Teachers Retirement System

16. **Major General Fund Costs in the Budget Year.** The budget includes General Fund transfers to the Teachers' Retirement Fund totaling \$835 million in 1993-94. 37
17. **General Fund Transfer to Supplemental Benefit Maintenance Account Overbudgeted.** The Governor's Budget overstates the amount of General Fund monies needed for statutory transfers to the Supplemental Benefit Maintenance Account by \$16.6 million. We recommend the Legislature recognize the availability of these funds as part of the Legislature's budget solution (General Fund savings of \$16.6 million). 39
18. **Redefining the State's Role in Teachers' Retirement.** We recommend that the Legislature enact legislation to establish an alternative benefit plan for future entering members of the STRS that is fully funded by member and employer contributions on an actuarially sound basis. (Eventual annual General Fund savings of roughly \$400 million—in today's dollars.) 40
19. **Option to Reduce General Fund Expenditures in 1993-94.** An option for reducing General Fund expenditures for the STRS in the budget year is to suspend or reduce the purchasing power benefit payments. 42

Department of Personnel Administration

20. **Employee Compensation.** During 1992 the DPA entered into memoranda of understanding (MOUs) with 20 of the 43

21 employee bargaining units. These MOUs call for pay increases that will cost the state an estimated \$234 million in the budget year and substantially larger amounts annually thereafter. We discuss these pay increases in further detail in our analysis of Item 9800—augmentation for employee compensation.

21. **Potential for Layoffs of State Employees Uncertain.** 44
Based on experience to date, it is unclear if additional layoffs will be necessary. Therefore, we recommend that the DPA and the State Personnel Board report at budget hearings on the status of and the potential need for layoffs in the current and budget years.
22. **Transfer of Health Benefits Administration from PERS.** 45
We withhold recommendation on the Governor's proposal to transfer administration of employee health benefits from the Public Employees' Retirement System (PERS) to the DPA, pending receipt of a detailed proposal, as discussed in more detail in our analysis of the PERS budget (Item 1900).

Health and Dental Benefits for Annuitants

23. **Budget Request.** We withhold recommendation on the \$330.1 million requested from the General Fund for Health and Dental Benefits for Annuitants pending final determination of premium rates being negotiated by the state. 46

Health Insurance Premiums

24. **Health Insurance Premium Rates for 1993-94 Have Not Been Determined.** We withhold recommendation on the monthly state contribution rates for annuitant health insurance specified in this section, pending final determination of the health insurance premium rates to be charged in the budget year. 46

Augmentation for Employee Compensation

25. **Legislature Has Option to Save More Than \$200 Million in 1993-94.** The Legislature has the option of saving more than \$200 million (including \$100 million General Fund) in 1993-94 by not funding the 5 percent general pay increases budgeted for state employees (other than those represented by Bargaining Unit 6—correctional employees). 48

Board of Equalization

26. **Legislature Should Create Line Item for Board and Appellate Function.** Recommend that the Legislature create a new line item in the budget for the support of the board members and the tax appellate function. 49
27. **Board's Proposal to Reduce Salary Savings Not Justified.** The board's assertion that reducing its salary savings results in additional revenue is unfounded. Recommend that the Legislature deny board's request for increased funding to reduce vacancy rates in audit and compliance positions. 50
28. **Gains From Additional Audit Staff Overstated.** The budget overstates revenue gains from back-filling auditors who have been re-assigned to use fuel tax audits. 52
29. **Legislature Should Explore Feasibility of Integrating Data Processing.** Recommend that the Legislature direct the board to determine the feasibility of integrating its central data processing with the Franchise Tax Board's data processing system. 53
30. **Budget Proposes New Formulas for Local Reimbursements.** Reimbursements to the board for the administration of local sales and use taxes will be \$12 million less in the current year and \$13 million less in the budget year than proposed in the budget unless legislation is passed to change reimbursement formulas. 54

Franchise Tax Board

31. **Budget Double-Counts Fee Revenue.** We recommend that the Department of Finance count fee revenue as an addition to tax revenue rather than a reimbursement to the FTB's budget. 56
32. **Fees May Be Adjusted.** We recommend that the FTB report at budget hearings the costs attributable to filing enforcement activities on businesses so the Legislature can establish fees for 1993-94. 57
33. **Budget Does Not Reflect Change in Tax Processing Workloads.** We recommend that the FTB report at budget hearings as to the administrative cost impacts for both the current year and 1993-94 of eliminating the Renters' Tax Credit program in 1992 and 1993. 57
34. **Settlement Authority Appears to Be Good State Tax Policy.** We recommend enactment of legislation to permanently allow the FTB to settle civil tax disputes with PIT and B&C taxpayers. 59

Tax Relief

35. **Legislature Should Act Promptly.** We recommend that the Legislature act by mid-March on the Governor's proposal to eliminate the Renters' Credit program for tax year 1992. 61
36. **Eliminate Homeowners' and Renters' Tax Relief Programs.** The administration's proposal to eliminate only the Renters' Credit program is not justified. Both obsolete programs, Homeowners' Exemption and Renters' Credit, should be eliminated, freeing up over \$800 million annually. 62
37. **1993-94 Alternative.** The Legislature can achieve the same effective reduction in expenditures as the Governor's proposal by suspending the Renters' Credit and temporarily reducing the mortgage interest deduction in 1993-94. 62

Department of General Services

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| 38. Fundamental Rethinking of DGS Support Services Needed. | 70 |
| Recommend that the Legislature take steps to introduce competition into the state's current system of support services and authorize a business audit of the support services now provided by the department. | |
| 39. 9-1-1 Surcharge Rate Should Be Reduced. | 73 |
| Recommend that the department and Board of Equalization decrease the surcharge rate to better reflect actual 9-1-1 system expenditures. | |
| 40. Information Needed on 9-1-1 Equipment. | 74 |
| Withhold recommendation on \$3.2 million, pending receipt and review of detailed department information. | |
| 41. Inadequate CALNET Fraud Prevention Proposal. | 74 |
| Recommend that the department provide a revised plan to the budget committees prior to budget hearings. | |

Office of Emergency Services

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| 42. Costs of Past Disasters Uncertain. | 76 |
| Recommend that the OES report to the Legislature, prior to budget hearings, on its estimates of disaster assistance costs for past disasters. | |
| 43. Certain Budget-Year Costs Not Estimated. | 77 |
| Recommend that the OES submit a report to the Legislature, prior to budget hearings, that: (a) includes projections of the state's disaster assistance costs for the budget year and (b) specifies which budgeted activities the OES proposes not to carry out in the event staff are reassigned to disaster response and recovery activities. | |
| 44. Legislative Oversight Needed. | 78 |
| Recommend that the OES report to the Legislature during budget hearings on the establishment of an internal mechanism for tracking disaster-related costs. | |
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Board of Control

45. **Significant Funding Shortfalls for Victims of Crime Program.** Recommend that the board report during budget hearings on the status of the projected current and budget year funding shortfalls and the program changes needed to address the shortfalls. 79

Military Department

46. **Reestablish Support of State Military Reserve (SMR).** Recommend denial of request to redirect \$189,000 from temporary emergency shelter program to reestablish state support for SMR because (a) the proposal is inconsistent with previous legislative action and (b) the department has submitted no justification. 83

Unallocated Reductions

47. **Unallocated Reductions—Section 3.90.** We recommend deletion of this control section because it would give the administration blanket authority to make \$150 million of budget reductions without the opportunity for meaningful legislative oversight. Instead, we recommend that the Legislature request the Department of Finance to present a specific list of proposed reductions. 84
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