GENERAL GOVERNMENT

LAO

65 YEARS OF SERVICE

2007-08 Analysis

Major Issues

General Government

☑ **Guaranteeing Teacher Benefit Not Advisable**

- The administration proposes to reduce contributions to the California State Teachers' Retirement System's purchasing power account—which protects retired teachers' benefits from being eroded by inflation—by $75 million on an ongoing basis. The reduction in contributions would be accompanied by a state guarantee of protection from inflation. There are risks to achieving the savings because the state could be obligated to make much higher contributions in the future if there is high inflation or poor investment returns. We recommend rejecting the proposal (see page F-68).

☑ **Cost-of-Living Increase for State Employees Appears Overbudgeted**

- The Governor's budget includes $549 million ($155 million General Fund) to pay for 2007-08 general salary increases for state employees. For employees in 15 of the state's 21 bargaining units, these raises are tied to a specific inflation rate for the 12 months ending in March 2007. The administration assumes that the inflation rate will be 3.3 percent. We believe the inflation rate (to be released in April) will be lower—an estimated 2.3 percent. This would save the state $100 million ($40 million General Fund (see page F-119).

☑ **Companion Publication: Increasing Oversight of Employee Compensation**

- In "Part V" of our companion publication *The 2007-08 Budget: Perspectives and Issues*, we make a number of recommendations that are geared towards improving the Legislature's oversight of employee compensation expenditures. Among our recommendations are for the Legislature to (1) limit the authority of arbitrators to order large payments based on their interpretation of future labor agreements and (2) end the use of automatic pay raise formulas tied to actions by other governmental employers.

☑ **Delete Midyear Reduction Authority for More Honest Budgeting**

- The administration assumes $146 million in General Fund savings from proposed authority to reduce departmental budgets during the year. Savings from these types of proposals are rarely achieved. For instance, it is unclear how the Department of Corrections and Rehabilitation will absorb a proposed $31 million reduction—given that the department has experienced budget shortfalls of more than $100 million every year since 2000-01. We recommend that the Legislature delete the proposed authority. The administration should identify any *specific* proposed savings in departmental budgets during the spring budget process and how it expects these savings to be achieved (see page F-126).

☑ **Governor Proposes Information Technology (IT) Changes**

- The Governor's budget proposes a $1.3 billion project over the next decade to develop a new statewide financial IT system that would be used by all departments. Our analysis discusses the primary components of this project proposal, key issues the Legislature should consider in evaluating the project, and recommends additional oversight tools if the Legislature decides the project should go forward (see page F-81).

- The administration also proposes a number of changes to the state's IT governance structure. While components of the proposal have merit, we recommend several changes. Specifically, in order to maintain objectivity, we recommend not moving IT project oversight from the Department of Finance to the Chief Information Officer (CIO). In addition, to avoid creating another layer of review, we recommend rejecting a separate security office. Instead, the CIO's new responsibilities should include data security (see page F-28).

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General Government

Overview

General Government

Total state funding for general government is proposed to increase by about 4 percent in the budget year. This increase primarily is due to the growth of employee compensation and retirement costs, partially offset by a one-time reduction in mandate payments to local governments.

The "General Government" section of the budget contains a number of programs and departments with a wide range of responsibilities and functions. For instance, these programs and departments provide financial assistance to local governments, regulate businesses, provide services to state agencies, enforce fair employment practices, and collect revenue to fund state operations. The *2007-08 Governor's Budget* proposes $7.6 billion in state expenditures (combined General Fund and special funds) for these functions. The proposed budget-year funding is $323 million (4.4 percent) more than estimated 2006-07 expenditures.

Spending by Major Program

There are three major program areas within general government:

- State administrative functions, which include a broad range of state departments.
- Tax relief and local government payments.
- State employee compensation, which includes increased salary and benefit costs for current and former employees.

We describe these program areas below, and Figure 1 (see next page) shows the estimated 2006-07 and proposed 2007-08 expenditures by program area.

Figure 1

General Government Spending by Program Area

(All Funds, In Millions)

Program	Estimated 2006-07	Proposed 2007-08	Difference Amount	Difference Percent
State administration	$3,702	$3,814	$112	3.0%
Tax relief/local governments	1,400	994	-406	-29.0
State employee compensation[a]	2,173	2,791	617	28.4
Totals	**$7,276**	**$7,599**	**$323**	**4.4%**

[a] Costs not reflected in departments' budgets, such as payments for retiree's health premiums.
Detail may not total due to rounding.

State Administration

Within general government, there are about 50 departments and agencies that serve a wide range of functions. Departments provide services to the public, regulate businesses, collect tax revenues, and serve other state entities. As described below, the Governor has proposed increased levels of expenditures in the budget year for some state departments.

Government Services. A number of departments provide government services to the public. These services include housing assistance, coordination of emergency responses, and assistance to veterans. The Department of Veterans Affairs (DVA) is the fastest growing department in this area, with a proposed increase in General Fund spending of $24 million. Among the administration's proposals for DVA are updated information technology (IT) systems and equipment replacement.

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

Tax Collection. The Franchise Tax Board (FTB) and the Board of Equalization (BOE) are the state's two major revenue collection agencies. The FTB is responsible primarily for collection and administration of the state's personal income tax and the corporation tax. In addition, it assists in the collection of various types of nontax delinquencies, including child support payments and vehicle-related assessments. The BOE is responsible primarily for administration and collection of the sales and use tax, as well as excise taxes on fuel, cigarettes, and alcoholic beverages. The budget proposes total funding of $806 million ($736 million General Fund) for these two agencies in 2007-08, down $39 million (5 percent) from the current year. This decrease is due largely to a decline in FTB expenditures for the California Child Support Automation System.

Services to Other Departments. Some state departments exist primarily to provide support for other departments. For instance, the Department of General Services assists state departments on purchasing and real estate decisions. The Department of Finance (DOF) acts as the state's fiscal oversight agency. Among the Governor's proposals are:

- The continued implementation of a new state payroll system at the State Controller's Office. The project will cost $40 million in 2007-08.
- The expansion of efforts to develop a new state fiscal system by DOF. The proposed project would cost $38 million in 2007-08 and $1.3 billion over the next decade.
- The reorganization of the state's governance of IT issues, including the funding of the State Chief Information Officer for the first time ($8 million).

Tax Relief and Local Government Payments

The state provides tax relief—both as subventions to local governments and as direct payments to eligible taxpayers—through a number of different programs. The major programs in this area are homeowners' property tax relief, various tax assistance programs for senior citizens, and open space property tax subventions. The state also makes payments to local governments for other programs, such as to reimburse local governments for state-mandated costs and to provide grants for public safety. The Governor's budget proposes to decrease General Fund payments in this area from $1.4 billion to $1 billion. This large decrease reflects (1) the administration's proposal to fund state mandates one year after local agencies incur costs and (2) the state's pre-payment of 2007-08 costs to retire its mandate backlog.

State Employment and Retirement

State Employee Compensation. The Governor's budget would increase state employee compensation—including salaries and expenditures for benefits such as health insurance and retirement—by an estimated

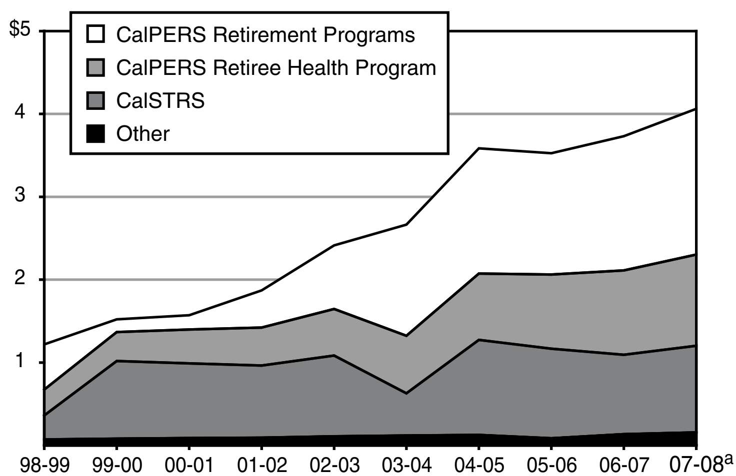
$1.2 billion in 2007-08. (A portion of these funds are provided in individual departmental budgets.) The vast majority of the funds address costs related to current labor agreements, court orders, and arbitration decisions. Nineteen of the state's 21 bargaining units—all except correctional officers and attorneys—have labor agreements that remain in effect until at least the end of 2007-08. Most of these agreements would provide employees with a general salary increase in 2007-08 based on inflation. Any costs associated with new agreements with the remaining two units would require additional spending.

Retirement Costs. The state contributes to the retirement of (1) state employees through the California Public Employees' Retirement System (CalPERS) and (2) public school teachers through the California State Teachers' Retirement System (CalSTRS). Retirement-related expenditures (from the General Fund and various special funds) account for a significant part of annual state spending. In 2007-08, as shown in Figure 2, General Fund expenditures for public employee retirement-related costs (excluding payroll taxes for employees' Social Security and Medicare benefits) are projected to exceed $4 billion for the first time. General Fund costs

Figure 2

Costs for Major State Retirement Programs

(General Fund, In Billions)



a Proposed. (CalPERS Retirement Programs amount based on system projections.)

for each of the major state retirement programs—CalPERS retirement (pension) benefits, CalPERS' retiree health program, and CalSTRS pension benefits—are expected to increase by 8 percent or more in 2007-08 due to the growth of state and school district payrolls and (in the case of the retiree health program) rising health care premiums. The 2007-08 budget package assumes the issuance of pension obligation bonds, with a net benefit to the state's General Fund of $525 million. Legal challenges have delayed the issuance of the bonds, and it is uncertain whether they can be issued during the budget year, if ever. In addition, the Governor's budget proposes to reduce the state's contributions to CalSTRS by $75 million on an ongoing basis by changing state law related to teachers' benefits. The budget includes no funds to address the possible legal liability associated with $500 million that the state did not pay to CalSTRS on a one-time basis in 2003-04.

CROSSCUTTING ISSUES

General Government

IMPLEMENTATION OF THE HOUSING BOND

In November 2006, voters approved Proposition 1C, which allows the state to sell $2.85 billion in general obligation bonds to fund existing housing programs as well as new programs that encourage housing developments. These bonds provide a major one-time infusion of state funds to be spent over several years. In this piece, we highlight key programs funded by Proposition 1C and identify issues and offer recommendations that the Legislature should consider to ensure the effective and efficient implementation of the bond measure.

Background

The state supports a variety of housing programs that target low- and moderate-income and homeless populations. Some of the programs, such as California Homebuyer's Downpayment Assistance (CHDAP), provide financial assistance so that low- and moderate-income families can purchase a home. Other programs, such as Multifamily and Supportive Housing, provide assistance for the construction, rehabilitation, and preservation of permanent and transitional rental housing for low-income and disabled individuals and households. These programs are generally supported by general obligation (GO) bonds and federal funds, and they are administered by the Department of Housing and Community Development (HCD) and the California Housing Finance Agency (CalHFA).

Between 1990 and October 2006, there were two bond measures passed by the voters for state housing programs:

- ***Proposition 107 (1990): $150 Million.*** The Housing and Homeless Bond Act authorized $150 million in GO bonds to supply housing for low-income and homeless Californians. The amount includes $100 million for new, affordable rental housing, $25 million for home purchase assistance for first-time homebuyers, $15 million in loans to acquire and rehabilitate residential hotels serving low-income populations, and $10 million for grants for the development and rehabilitation of emergency homeless shelters.
- ***Proposition 46 (2002): $2.1 Billion.*** The Housing and Emergency Shelter Trust Fund Act authorized $2.1 billion in GO bonds for 21 housing programs. At the time, it was the largest housing bond ever approved by California voters.

According to HCD and CalHFA, all of the Proposition 107 funds have been committed to fund selected housing projects. The departments estimate that, as of the end of 2006, about $344 million in Proposition 46 funds have not been awarded.

Major Provisions of Proposition 1C

In November 2006, voters approved Proposition 1C, authorizing the use of $2.85 billion in GO bond funds for various housing purposes.

Fund Allocation. Specifically, Proposition 1C allocates $2.85 billion to 13 housing and development programs, as shown in Figure 1. A little more than one-half of the funds (about $1.5 billion) is subject to legislative appropriation. This includes funds designated for three new development programs and funding for the current Building Equity and Growth in Neighborhood program (BEGIN). All other programs in Proposition 1C are continuously appropriated. The major allocations of the bond proceeds from Proposition 1C are:

- ***Development Programs ($1.35 Billion).*** Almost one-half (47 percent) of the bond money, when appropriated by the Legislature, will fund three new programs to promote urban development and parks. The programs are Regional Planning and Housing and Infill Incentive, Transit-Orientated Development, and Housing Urban-Suburban-and-Rural Parks. These programs will provide loans and grants for a wide variety of projects, including water, sewage, transportation, traffic mitigation, brownfield cleanup, parks, and housing around and near public transit.
- ***Homeownership Programs ($625 Million).*** About one-fifth (22 percent) of the bond funds will be available for four programs-CalHome, CHDAP, BEGIN, and Self-Help Construction Management-that assist and encourage homeownership for low- and

Figure 1

Proposition 1C—Use of Bond Funds

(In Millions)		
Development Programs		**$1,350**
Regional Planning, Housing and Infill Incentive	Grants for projects—including parks, water, sewer, transportation, and environmental cleanup—to facilitate urban "infill" development.	$850
Transit-Orientated Development	Grants and loans to encourage more dense development near transit.	300
Housing Urban-Suburban-and-Rural Parks	Grants for parks throughout the state.	200
Homeownership Programs		**$625**
CalHome	Homeownership programs for low-income households, such as loans for site development.	$290
Homebuyer's Downpayment Assistance	Deferred low-interest loans for up to 6 percent of home purchase price for first-time low- or moderate-income homebuyers.	200
Building Equity and Growth in Neighborhoods	Grants to local governments for home-buyer assistance.	125
Self-Help Construction Management	Grants to organizations which assist low- or moderate-income households in building or renovating their own homes.	10
Multifamily Housing Programs		**$590**
Multifamily Housing	Low-interest loans for housing developments for low-income renters.	$345
Supportive Housing	Low-interest loans for housing projects which also provide health and social services to low-income renters.	195
Homeless Youth	Low-interest loans for projects that provide housing for young homeless people.	50
Other Housing Programs		**$285**
Farmworker Housing	Low-interest loans and grants to develop housing for farm workers.	$135
Affordable Housing Innovation	Grants and loans for pilot projects that create or preserve affordable housing.	100
Emergency Housing Assistance	Grants to develop homeless shelters.	50
Total		**$2,850**

moderate-income homebuyers. In general, these programs aim to lower the cost—whether in the form of downpayment assistance or ongoing mortgage interest payment—of housing. Typically, eligibility for these assistance programs is based on the household's income, the cost of the home the applicant(s) want to buy, and whether or not it is the household's first home purchase.

- ***Multifamily Housing Programs ($590 Million).*** Another one-fifth (21 percent) of the bond funds will be available for programs that focus on the construction or renovation of multifamily rental housing projects, like apartment buildings, for the low-income population as well as homeless youth and the disabled. Specifically, the programs will provide local governments, nonprofit organizations, and private developers with low-interest (3 percent) loans to fund part of the construction cost. In exchange, a project must reserve a portion of its units for low-income households for 55 years. Projects in areas where there is a need for infill development and are near existing public services will receive funding priority.
- ***Other Housing Programs ($285 Million).*** These programs, such as Farmworker Housing and Homeless Shelters, provide loans and grants for the development of homeless shelters and housing for farm workers. Proposition 1C will also fund pilot projects aimed at reducing the costs of affordable housing through the Affordable Housing Innovation program.

While HCD will administer most of the programs, CalHFA will also be involved. Specifically, CalHFA will manage CHDAP and the Residential Development Loan Program, which is funded by CHDAP.

Proposition 1C Funds Both Existing and New Programs. In total, Proposition 1C will provide $1.35 billion to continue funding eight existing programs for which Proposition 46 has also provided funding. Figure 2 shows the amount of bond funds allotted by Proposition 1C for these programs compared to the amount provided by Proposition 46. The remaining Proposition 1C funds ($1.5 billion) will be for five new programs created by the measure: Regional Planning and Housing and Infill Incentive, Transit Orientated Development, Housing Urban-Suburban-and-Rural Parks, Affordable Housing Innovation, and Homeless Youth programs.

Governor's Proposal

The Governor's budget proposes total expenditures of $820 million from Proposition 1C funds in the current and budget years combined. Figure 3 (see page 18) summarizes the expenditures by programs. Specifically:

- Development Programs: $228 million.

Figure 2

Funding of Continuing Housing Programs

(In Millions)

Program	Proposition 46	Proposition 1C
Multifamily Housing	$800	$345
CalHome	115	290
Homebuyer's Downpayment Assistance	118	200
Supportive Housing	195	195
Farmworker Housing	155	135
Building Equity and Growth in Neighborhoods	75	125
Emergency Housing Assistance	195	50
Self-Help Housing (Construction Management)	10	10
Totals	**$1,663**	**$1,350**

- Homeownership Programs: $164 million.
- Multifamily Housing Programs: $341 million.
- Other Housing Programs: $87 million.

Of the total amount, $160 million will be expended in the current year for five programs, including four existing programs (CalHome, Multifamily Housing, Supportive Housing, and Farmworker Housing) and one new program (Homeless Youth) that Proposition 1C created. The remaining $660 million will be expended in 2007-08 to provide funding for all 13 programs under the bond measure.

Issues for Legislative Consideration

In implementing Proposition 1C, there are several issues that warrant further consideration by the Legislature to ensure that the bond program is carried out in a timely and cost-efficient manner that achieves the goals of the program.

New Programs Need Further Legislative Definition of Project Selection Criteria. As noted earlier, Proposition 1C establishes five new funding programs. For three of these programs, the measure does not provide any specific directions regarding funding eligibility and criteria to be used to evaluate project funding applications. The three programs are: Regional Planning and Housing and Infill Incentive, Housing Urban-

Figure 3

Governor's Proposed Expenditures

(In Millions)

Programs	2006-07	2007-08
Development		
Regional Planning, Housing, and Infill Incentive	—	$101
Transit-Orientated Development	—	96
Housing Urban-Suburban-and-Rural Parks	—	31
Homeownership		
CalHome	$35	$56
Homebuyer's Downpayment Assistance	—	30
Building Equity and Growth in Neighborhoods	—	40
Self-Help Construction Management	—	3
Multifamily Housing		
Multifamily Housing	$70	$141
Supportive Housing	20	80
Homeless Youth	15	15
Other Housing		
Farmworker Housing	$20	$41
Affordable Housing Innovation/Pilot Programs	—	16
Emergency Housing Assistance	—	10
Totals	**$160**	**$660**

Suburban-and-Rural Parks, and Affordable Housing Innovation. Rather, Proposition 1C only provides broad project categories that may be funded under these programs.

Regarding the use of the Affordable Housing Innovation Fund ($100 million), Proposition 1C specifically requires that eligibility criteria be first enacted in statute and approved by a two-thirds vote of the Legislature, before funds can be allocated for pilot programs that demonstrate "innovative, cost-saving approaches" to create or preserve affordable housing. However, for the other two programs—$850 million for regional planning, housing, and infill incentives and $200 million for parks—Proposition 1C does not explicitly call for further statutory direction, other than making the funds available for a broad range of projects. Such projects include water, sewer, transportation improvements, traffic mitigation, brownfield cleanup, as well as parks that encourage infill and housing developments. As a result, it would be up to the implementing department to determine how the funds should be used as "incentives" to leverage other housing investments, or whether a certain category of eligible projects should have higher priority over others. The measure also leaves it open as to whether these funds should be provided on a competitive or first come, first serve basis.

Absent further legislative direction, the administration will have broad discretion to allocate funds to projects, potentially in ways not consistent with legislative priorities. Accordingly, we recommend the enactment of legislation to provide further direction to the allocation of these funds, including project eligibility, funding priorities, as well as criteria to be used to select projects. Specifically, we recommend that this funding be made available on a competitive basis. Projects should be evaluated using objective criteria which include the housing impact of the proposed projects, as well as the amount of other funds that would be leveraged with the bond money.

Designate Lead Department for New Program. The HCD and CalHFA will administer most of the Proposition 1C funded programs. Proposition 1C, however, does not designate an agency to administer the $850 million for infill incentives and $200 million for park development. As the Legislature further defines these two programs (as discussed above), it should consider which state entity is best suited to administer these funds and equipped to evaluate grant applications. For instance, Proposition 84 (the park and water bond also approved in November 2006) includes $400 million for local and regional parks. These funds will be administered by the Department of Parks and Recreation (DPR) which, for many years, has had an established process to implement bond-funded grants and loan programs for park development. We believe that designating DPR as the primary administrator of all bond funding for parks (including Propositions 1C and 84) would likely result in lower overall state administrative costs, more consistent project evaluation and better coordinated project selection, than if two agencies (DPR and HCD) administer separate grant programs for park development.

Coordination With Other Departments Essential. The HCD should coordinate with various transportation agencies in implementing the transit-oriented development program. Proposition 1C designates HCD as the administrating agency for the $300 million in transit-oriented development funding, although the department has only limited experience in dealing with transit-orientated housing development projects. At the same time, Proposition 1B (the transportation bond measure that voters approved in November 2006) provides $3.6 billion for transit improvements including the purchase of vehicles to expand services and construction of rail and facilities such as transit stations. Coordination between HCD and various transportation agencies on such matters as project evaluation criteria and timelines for projects would improve the effectiveness of both programs. We recommend that HCD advise the Legislature during budget hearings on the ways in which it intends to coordinate with the various transportation agencies.

Timing of Funding Availability. While Proposition 1C provides a significant amount of funding for housing on a one-time basis, there are, as we discuss below, good reasons for not expending all the funds at one time, but rather over several years.

The HCD indicates that, as in past practice, it plans to make the bond funds for certain programs, such as CalHome and Farmworker Housing, available for project funding over several years. This would allow several granting cycles to be established. While this reduces the amount of funding immediately available, it would improve the overall quality of the applicant projects competing for funds, thereby improving the quality of projects eventually funded. This is because if too large an amount of funding were awarded at any one time, it is possible that low-scoring projects would be funded. By making the funds available over multiple cycles, there is more time for project sponsors and applicants to develop project applications.

We think the department's approach is reasonable. We recommend that for each of these programs, the department advise the Legislature during budget hearings on the number of cycles it intends to establish, the schedule for the cycles, and the approximate amount of funding that it plans to make available for each cycle. The information would enable the Legislature to better monitor the program's progress. It would also allow grant applicants to plan when they will compete for funds.

Require Periodic Reporting for Legislative Oversight. In addition to providing further direction on funding eligibility and project selection criteria, as discussed earlier, the Legislature should exercise ongoing oversight of the bond program to make sure that funds are expended in an effective and timely manner to achieve program objectives. To facilitate ongoing oversight, we recommend that the Legislature require that certain information be provided to it annually.

Current law requires HCD to annually report specific information for various Proposition 46 housing programs, including the following:

- Number of housing units assisted by the programs.
- Number of individuals and households served and their income levels.
- The distribution of units among various areas of the state.
- The amount of other public and private funds leveraged by the assistance provided by the programs.

- Information detailing the assistance provided to various population groups by program.

We think that the information required by current law for Proposition 46 provides measures of the effectiveness of the housing programs, and should be required for Proposition 1C housing programs as well. Proposition 1C requires only that HCD report generally on how specific housing funds are expended. The HCD indicates that given the current law requirement, it together with CalHFA, will provide for each of the housing programs funded under Proposition 1C similar information as is currently reported for Proposition 46 programs.

As indicated earlier, Proposition 1C contains funds for programs that do not directly provide housing but rather fund improvements that encourage housing development. These programs are the infill incentive, transit-oriented development, and parks programs. However, Proposition 1C does not include any reporting requirements for these programs. Because these new programs do not fund housing per se, we think it is even more important that the effectiveness of these programs in terms of housing development be monitored and assessed. Accordingly, we recommend that the Legislature enact legislation that requires the administering entity of these programs to provide information annually on the projects funded, the amount of funding provided to each project, the fund recipient, and the amount of housing to be developed as a result of the projects. The information should be collected by HCD and presented in a consolidated annual report to facilitate oversight of the entire bond program.

Hold Joint Legislative Hearings. Beyond requiring specific information through annual reporting, we further recommend that the policy committees and budget subcommittees of the Legislature hold periodic, joint hearings on the implementation of the bond measure. The hearings would provide the Legislature an opportunity to monitor the progress of the bond program in the aggregate and assess whether the program is achieving the goals of providing housing in an effective and timely manner.

Conclusion

The passage of Proposition 1C provides the state with funding to address affordable housing issues for many Californians, including low- and moderate-income individuals and disabled and homeless populations. However, it is important that the bond funds are used to achieve the bond program's objective in promoting housing in an efficient and cost-effective manner. In this piece, we have recommended actions that will help the state meet these goals.

TAX AGENCY INFORMATION AND DATA EXCHANGE

Background

California has for decades primarily relied on three different state agencies to administer and enforce its taxes—the Board of Equalization (BOE), the Franchise Tax Board (FTB), and the Employment Development Department (EDD). While this system has performed reasonably well in many respects, the multiagency nature of the system is prone to certain inherent problems, difficulties, and inefficiencies. One particular area of concern is the challenges that California's tax agencies face within the multiagency framework in sharing the tax-related information and data they need to effectively and efficiently administer the overall tax system.

Given this situation, the Legislature adopted supplemental report language in conjunction with the *2005-06 Budget Act* requiring our office to examine (1) the extent of information and data exchange among the state's three main tax administration agencies, and (2) the impediments to, and opportunities for, increasing the current level of cooperation in this regard. The language placed an emphasis on how additional cooperation could serve to improve overall tax compliance as well as aid in tax enforcement activities. Our completed report—*A Report on Tax Agency Information and Data Exchange* (January 2007)—was prepared utilizing data and other information provided by the tax agencies.

Report Findings

The tax agencies identified a number of short-term steps that could be taken to facilitate the exchange and use of certain tax-related data and information.

Specifically, the tax agencies identified a variety of data items which are now being collected by state agencies but which are not being shared. They also highlighted various other sources of information collected by the federal government as well as by private entities that would be of use in improving tax compliance.

Over and above a greater sharing of data that are already collected, our report identified several programs that could be established that would enhance the ability of the agencies to develop, obtain, and share data. Virtually all of these programs would entail additional budgetary funding, primarily for the purpose of addressing technological constraints of existing data systems.

The Issue of a Single Taxpayer Identification Number

The Legislature specifically asked that our report consider the value of developing a single taxpayer identification number to help ease the difficulties tax agencies have in sharing and cross-matching data.

Although the use of a single taxpayer identification number could greatly simplify things for the taxpayer, our report found that it raises a number of significant administrative issues, as well as identity-theft concerns. We thus concluded that a single taxpayer identification number may not be the most appropriate means of linking the ability of the tax agencies to share data. Instead, increasing the ability of the agencies to cross-match taxpayer information using their existing systems in conjunction with an alternative technology approach—with the flexibility this would maintain for each of the agencies—seems most appropriate.

LAO Recommendation

Based upon our above-cited report and in order to ensure that timely progress is made in the area of information and data sharing, we recommend that the Legislature direct the state's main tax agencies—BOE, FTB, and EDD—to appear jointly before the budget committees when the 2007-08 budget is being reviewed to report on:

- Those cost-efficient, data-sharing actions they are planning to undertake or could undertake immediately (that is, which require no additional funding or statutory changes).
- Relevant information and recommendations regarding other initiatives that may require legislative actions (such as statutory changes or added funding).
- An alternative technology approach, such as using software overlays, to link existing independent tax information systems—including its costs, benefits, and time requirements.

In discussing these matters, the agencies should also collectively identify their preferred means for coordinating data-related decisions and activities amongst themselves, such as use of the already established Strategic Tax Partnership or other alternative approaches.

DEPARTMENTAL ISSUES

General Government

GOVERNOR'S OFFICE (0500)

This item provides the Governor with funds for his personal staff to coordinate the administration's operations. The Governor's budget proposes expenditures of $19.7 million from the General Fund, an increase of 5.6 percent from estimated current-year expenditures. More than 83 percent of the Governor's Office budget is for personnel costs. The proposed budget would support 185 positions.

Autopilot Spending Unnecessary

We recommend that the Legislature reject the administration's proposal to automatically increase the Governor's Office budget annually. The administration has offered no policy rationale as to why the current process is not working, and it would result in overbudgeting of the office in 2007-08. (Reduce Item 0500-001-0001 by $356,000.)

Recent Budgeting for the Office. Traditionally, the Governor's Office has been budgeted like other state departments. If the Governor's Office identifies a staffing problem, it can submit a budget change proposal to the Legislature seeking an augmentation. In addition, until 2004-05 the Governor "borrowed" many staff from other state departments to assist the office with its work. These positions often were borrowed for long periods of time. To better reflect the number of staff actually working in the Governor's Office and increase transparency, the Governor proposed and the Legislature approved in the *2004-05 Budget Act* a permanent transfer of borrowed staff to the Governor's Office. Consequently, the Governor's Office budget grew from $6.1 million to $18.4 million between 2003-04 and 2004-05. Likewise, the official staff count grew from 86 to 188 over the same time period.

Proposed Automatic Adjustment. The administration proposes to switch the Governor's Office budget from traditional budgeting to an automatic annual adjustment. Specifically, the office's budget would be increased annually by the percentage growth in the state appropriations limit (SAL). The SAL grows annually by a population and cost-of-living factor. (The administration made a similar proposal last year but eventually withdrew the request.) In the budget year, applying the SAL to the Governor's Office raises costs by $986,000. As its rationale for the budgeting change, the administration points to similar growth factors for the legislative and trial court budgets.

Legislature's Adjustment Was Accompanied by a Cap and Major Budget Reduction. In passing Proposition 140 in November 1990, the voters reduced the Legislature's budget by more than *one-third.* The measure also instituted a cap on the Legislature's appropriation amount. This cap grows annually by the SAL factor so that legislative expenses can increase with the economy over time—from the reduced base. (Proposition 140 also implemented other changes related to the Legislature, such as term limits and ending legislators' retirement benefits.) The administration does not propose either a cap or a reduction.

Trial Court Funding Program Has Unique Issues. As part of the 2004-05 budget, a portion of the judicial branch budget—the Trial Court Funding Program—was placed under the SAL funding methodology similar to what is proposed for the Governor's Office. However, this was largely intended to provide trial courts with a rough idea of future resources during their local employee compensation negotiations.

Proposal Overbudgets Office. The administration reports that it intends to have the same number of staff in the Governor's Office in 2007-08 as in the current year. For the proposed 2007-08 budget, the administration first built into the Governor's Office's budget the costs associated with increased benefits (such as the state's share of health premiums). The administration, however, did not provide two baseline adjustment to the Governor's Office that were generally provided to other departments: (1) the 3.5 percent cost-of-living pay raise provided in 2006-07 for employees (about $555,000 for the employees in the Governor's Office) and (2) the inflationary costs of operating expenses (about $75,000). The requested SAL adjustment of $986,000 would therefore provides $356,000 more than the amount necessary to keep the Governor's Office fully funded. (Any increased compensation costs for 2007-08 could be funded from Item 9800—Augmentation for Employee Compensation.)

Reject Automatic Spending Increases. Like other state departments, the Governor's Office should propose spending increases based on staff workload. The administration has offered no policy reason why the current process is not working. We therefore recommend that the Legislature reject the SAL proposal. In addition, the provision of a SAL adjustment for 2007-08 resulted in overbudgeting the office's expenses. Accounting for increased salary and operating costs, we recommend a reduction of $356,000 to the Governor's Office budget.

OFFICE OF THE CHIEF INFORMATION OFFICER (0502)

The Office of the Chief Information Officer (CIO) was created by Chapter 533, Statutes of 2006 (SB 834, Figueroa). The CIO is a member of the Governor's cabinet and advises the Governor on information technology (IT) issues. In funding the office for the first time, the Governor's budget proposes 46.5 positions and expenditures of $7.9 million for CIO. These costs would be paid by state departments through the Department of Technology Services' rate structure. Included in this proposal are 20.9 new personnel-years (PYs) to handle the office's administrative and policy development work. In addition, the Department of Finance (DOF) Office of Technology Review, Oversight and Security (OTROS) would be transferred out of DOF. The proposal includes transferring: (1) 25.6 OTROS PYs to CIO to continue the review and oversight of IT projects and (2) 3 OTROS PYs to the newly formed Office of Information Security and Protection within the State and Consumer Services Agency (SCSA) to manage the state's information security program. We discuss the proposal in detail below.

IT GOVERNANCE CHANGES

The administration proposes a number of changes to the state's information technology (IT) governance structure. Our analysis finds that (1) the planning and policy development roles are appropriately placed with the Chief Information Officer (CIO), (2) moving IT project oversight to CIO would eliminate objectivity, and (3) a separate security office may create an unnecessary layer of review. We recommend the Legislature adopt an alternative structure that addresses these concerns.

The state annually makes large IT investments to improve the management and oversight of programs and the quality of its services to the public.

These efforts require the involvement of state staff who are program and IT experts, as well as control agencies which are responsible for ensuring that state funds are spent effectively and consistent with state laws and policies. Historically, the state has struggled to complete IT projects on time and on budget. As we have discussed in prior publications, one of the significant contributors to past problems has been the lack of well-defined roles and responsibilities for key entities. While departments have been responsible for developing and implementing individual projects, which entities are responsible for four key statewide roles has been less well-defined.

- ***Strategic Planning.*** Strategic planning determines where the state's IT is going over the next few years. It includes establishing a set of goals to be achieved.
- ***Policies and Standards.*** Policies and standards are developed in order to provide a framework for achieving the strategic goals. These give direction, structure, and consistency to departmental IT projects. While policies are general strategies, standards are more specific in nature.
- ***Project Review, Approval, and Oversight.*** Proposed IT projects are reviewed by departmental management and control agencies to ensure the projects will meet the programs' business needs, are cost-effective, and align with the state's strategic direction. Once approved for implementation, oversight provides independent and objective monitoring to ensure the project stays within its planned scope, schedule, and budget.
- ***Information Security.*** Information security employs policies, standards, and other tools to protect data from unauthorized access and use.

Although the state has tried a number of IT governance models over the past three decades, none has proven to be an effective, long-term solution. In our view, the failure to establish a coherent and effective IT governance structure continues to place the state at risk of not completing IT projects on time and on budget. In this piece, we first describe the current IT governance structure, then discuss the administration's proposed changes, and finally recommend an alternative solution.

Current IT Governance Structure

In 2002, the Legislature allowed the Department of Information Technology (DOIT) to sunset after seven years of struggling to meet its statutory mandates to oversee the state's IT structure. In its place, the Legislature funded an interim IT governance structure which heavily relies on DOF to perform multiple roles.

Strategic Planning. In 2002, the Governor appointed a CIO to be an advisor on the state's IT strategic direction. At the cabinet level, it is the CIO's role to be knowledgeable about IT tools and trends and to work with department executives to develop a plan to support the successful delivery of state IT solutions. In 2004, the CIO first published the California IT Strategic Plan. This plan includes a set of goals for improving the use of IT. Prior to Chapter 533, the CIO was not authorized by state law, and the CIO currently has no formal staff or budget.

Policies and Standards. Since the sunset of DOIT, OTROS has worked within DOF to produce state IT policies and standards. These are published in the State Administrative Manual and the State Information Management Manual. In addition, the Department of General Services has developed a set of policies and standards to guide state IT procurements.

Project Review, Approval, and Oversight. In the current structure, OTROS reviews IT projects for risk and benefit. The OTROS analysts coordinate their reviews with the associated DOF budget analyst so that IT projects are approved for funding within the context of the state budget situation. In poor economic times, DOF has denied funding for new IT projects and delayed projects that were in progress in order to manage costs. For projects that are approved for implementation, OTROS has developed a three-tier oversight process. Projects are categorized by key factors—such as cost and the experience of the project manager—to determine if they are low, medium, or high risk. Low- and medium-risk projects are principally overseen at the departmental and agency levels. Focusing on high-risk projects, OTROS performs independent oversight to see that projects stay within scope, schedule, and cost.

Information Security. Three PYs within OTROS currently manage the state's information security program. A limited set of security policies have been issued, but DOF largely requires that departments develop their own security policy framework. To date, security has not been a prominent focus for OTROS.

Proposed IT Governance Structure

Chapter 533 lays out very broad roles for CIO. In its budget proposal, the administration significantly expands those roles to make CIO the key agency of its proposed IT structure.

Strategic Planning. The CIO has developed and led state IT strategic planning efforts over the past few years, and the administration's proposal continues this role for CIO.

Policies and Standards. Under the administration's plan, responsibility for developing IT policies and standards would be transferred from

DOF to CIO. The CIO would be charged with aligning these policies and standards with the state strategic plan.

Project Review, Approval, and Oversight. The administration proposes to move IT project review, approval, and oversight from DOF to CIO. Most OTROS staff would be transferred to CIO. Approved projects would then receive ongoing oversight by CIO. The administration reports that it expects project reviews and oversight to continue in a similar manner.

Information Security. The administration proposes to transfer DOF's three security positions out of the department. The security positions would be combined with the current 8.3 positions in the Office of Privacy Protection in the Department of Consumer Affairs (DCA) to form a new Office of Information Security and Privacy within SCSA. The new office would combine the responsibility for "protecting the state's information assets" with "developing consumer education programs."

Some Merit, but Proposal Raises Concerns

Planning, Policies, and Standards Makes Sense at CIO. We believe that the administration's proposal to place responsibility for the state's IT planning, policy, and standards with CIO makes sense. The CIO's knowledge of IT industry tools and trends makes this a natural alignment. The CIO role will tend to involve advocacy for those projects which are consistent with these policies and promote the state's IT strategic plan. We do, however, have concerns with other aspects of the proposal.

Overly Ambitious Plans for CIO. In organizing CIO, the budget proposal lists 15 major goals that will come from its formation—including improving IT procurements, enhancing training of state staff, and reorienting the state's Web pages. There is no prioritization reflected in the proposal. Particularly in CIO's early years, we are concerned that such an aggressive agenda will result in reduced effectiveness. In fact, the same problem plagued DOIT during its existence. In a 2003 report, the Bureau of State Audits found that "DOIT attempted to make inroads on many issues, perhaps too many issues, all at once. This scattershot approach did not allow it to garner accomplishments that would engender support and credibility."

Separating Approval From Funding Creates Risks. The CIO would have no project funding authority, which would remain with DOF's budget staff. In theory, CIO would turn over an approved project to DOF to be fully funded. In practice, however, this could be a challenging process to manage and would require a high level of coordination and information sharing between DOF and CIO. The proposal provides no plan for coordinating project approval and funding. Departments could end up with a project approved by CIO's office and still be denied funding by DOF. This is another problem that contributed to DOIT's failure. At the time, DOIT's responsibility was to approve project plans based on sound management practices and DOF's responsibility was to approve project budgets. Yet, DOF often approved projects at funding below the level recommended by DOIT. Eventually, DOIT's role became diminished because it did not have the financial clout to support its decisions.

Oversight Must Be Independent. As a control agency, DOF performs the role of dispassionate review of state programs and projects. This makes its IT oversight more effective by adding objectivity to the process. We are concerned, however, that CIO's advocacy for projects will limit its ability to provide an independent perspective on oversight.

Security Proposal Would Add Unnecessary Layer. Information security has not received priority within DOF. Security policies can increase costs, which runs counter to DOF's core mission of controlling costs. Moving the security program out of DOF, therefore, is a positive step. The administration's choice in moving IT security to SCSA appears to be an effort to follow industry practices to separate the CIO from security. To the extent that projects will receive security reviews by SCSA under the new structure, however, it would add another cumbersome layer of review in addition to CIO and DOF. It is also unclear how policies issued by CIO would be integrated with security policies issued by SCSA.

Recommend Alternative Structure

Based on the concerns raised above, we recommend that the Legislature amend the administration's proposed IT governance structure. Our recommendation emphasizes CIO's role as a strategic office, while maintaining specific project review and approval at DOF. We describe our alternative below.

Strategic Planning, Policies, and Standards. The administration's proposal to place these responsibilities with CIO makes sense. The CIO would be the state's IT program expert and should be responsible for its planning and policy development.

Project Review, Approval, and Oversight. The current IT project funding and oversight structure has produced a reasonable approach to identifying and managing project risks and has provided balance between risk management and funding constraints. One key component is that DOF has the authority to approve, fund, and oversee a project. In addition, particularly in the short term, CIO will have other priorities upon which to focus. Adding the management of every state IT project to CIO's workload will stretch its capabilities, even with OTROS staff relocated.

We therefore recommend that OTROS's project review and oversight roles remain at DOF. The CIO would still be involved in the development of key IT projects. The CIO's involvement, however, would be from a strategic perspective rather than the "nuts and bolts" of detailed reviews.

Information Security. Information security should receive more focus than it has received under the current structure. Creating a third IT review office (in addition to CIO and DOF), however, could unnecessarily hinder project reviews. We instead recommend that the security function be included within CIO's policies and standards role. As CIO issues statewide policies, it should include the perspective of how security is affected and data could be better protected. The three security positions currently at DOF should be transferred to CIO. We recommend leaving the Office of Privacy Protection within DCA where it can continue its consumer-oriented role.

OFFICE OF EMERGENCY SERVICES (0690)

The Office of Emergency Services (OES) is responsible for assuring the state's readiness to respond to and recover from natural and man-made emergencies. During an emergency, the office functions as the Governor's immediate staff to coordinate the state's responsibilities under the Emergency Services Act. It also coordinates federal assistance for natural disaster grants. Since 2003-04, OES has administered criminal justice grant programs formerly managed by the Office of Criminal Justice Planning. Funding for the Office of Homeland Security (OHS) is also included in the OES budget.

The budget proposes to spend approximately $1.3 billion in support of OES in 2007-08. Over $1 billion of this amount is from federal funds, primarily local assistance funding for disaster assistance and homeland security grants. The department's General Fund spending is proposed to grow by 3 percent to $185 million.

BOND FUNDING FOR SECURITY PROGRAMS

Port Security Proposal Ignores Availability of Bond Funds

We recommend deleting a $5 million proposal for port security grants from the Antiterrorism Fund. Recently approved bond funding provides $100 million for the same purpose. (Delete Item 0690-111-3034.)

Ports and Funding for Security. The state has about a dozen public ports and harbors, which import hundreds of billions of dollars in goods each year. Since the terrorist attacks of September 11, 2001, there has been considerable national concern about the vulnerability of ports to future attacks. Consequently, California's ports have received about $142 million in federal grants over the past five years to upgrade their security. While a small portion of these federal funds was distributed to ports by OHS ($5 million), the remaining funds were provided directly to the ports by the federal government.

Proposed New Program. The Governor's budget proposes \$5 million in 2007-08 to establish a state-funded grant program for port security, with ongoing funding of \$1 million in subsequent years. Funding for the program would come from the state Antiterrorism Fund, which receives its support from the sale of California memorial license plates. The department's priority would be the creation of a worker identification program. The proposal contains no details regarding the worker identification program, but the proposed large one-time grants in 2007-08 would presumably be for necessary equipment and other startup costs. The administration would specify how much funding each port would receive—from \$150,000 for smaller ports to \$775,000 each for the Ports of Los Angeles and Long Beach.

Proposal Ignores Availability of Bond Funds. The proposal ignores the availability of \$100 million for port security from the Proposition 1B transportation bond passed in November 2006. The bond specifies OES as the administrator of these grant funds, which are intended to focus on equipment purchases. (We discuss the Legislature's choices in implementing bond-funded programs below.)

Antiterrorism Fund Is Flexible. The Antiterrorism Fund is the state's only dedicated fund source for homeland security activities, and the original intent of the fund was to address multiple departments' homeland security requests. Since it can be used to fund activities that are ineligible for federal funding, the fund is an important flexible tool for the Legislature. For instance, the Legislature was able to use the fund to pay for homeland security activities of the Department of Food and Agriculture in 2006-07 that otherwise would have been borne by the General Fund. The proposed use of the Antiterrorism Fund for port security would take most of the fund's resources in 2007-08 and in future years. (The fund currently has a comparatively large fund balance due to minimal spending in prior years.) As such, the proposal would leave little funding available for other departments.

Recommend Deleting Funding. Given the availability of bond funds for port security, we recommend the Legislature delete the proposed funding from the Antiterrorism Fund. The Antiterrorism Fund should be preserved for spending that has no other available funding source. As discussed in more detail below, we believe that port security should be addressed through competitive grants using bond proceeds.

Bond Programs Need Framework

We recommend that the Legislature provide more specific statutory frameworks for the port and transit security grant programs funded by the recent transportation bond. We recommend the funds be distributed

competitively in a manner which provides long-term benefits and leverages other funds.

Bond Funds for Security. As noted above, Proposition 1B provides $100 million for port security equipment grants to be administered by OES. In addition, the bond provides $1 billion for transit security without specifying a state administering department. The administration proposes (through trailer bill language) that OES administer the transit security program as well. The Governor's budget does not propose appropriations for either program.

OES Makes Sense for Both Programs. In our view, OES administering both programs is reasonable for a number of reasons. First, OES has considerable experience administering grant programs. Second, OES is the state's lead agency related to emergency preparedness and homeland security (in conjunction with OHS). Finally, the two programs are similar in purpose, so a single administrating department should be able to achieve efficiencies by running both programs.

Structure Bond Programs for Long-Term Benefit and Competitive Selection. As we discuss in more detail in our recent report *Implementing the 2006 Bond Package* (January 2007), the Legislature should take an active role in crafting the frameworks for the new programs authorized by the bond in order to ensure their success. Below, we provide some key considerations in developing the frameworks for these two security programs.

- ***Long-Term Benefit.*** The Legislature should ensure that the bond proceeds only support projects that will provide a long-term benefit to the state. Otherwise, it would mean that future taxpayers decades from now would be paying bond debt service for the short-term benefits enjoyed by today's California residents. For instance, the Legislature should require that any equipment purchased with the funds have a reasonably long expected lifespan.
- ***Defining Goals and Priorities.*** For both programs, Proposition 1B provides only broad parameters for how the funds should be used. Prior to appropriating any funds for the programs, the Legislature should further define the specific goals and priorities of the programs to focus the funding in those areas which can most improve the state's overall security.
- ***Competitive Selection.*** In addition, the Legislature should define the criteria for selecting projects. The administration's port security program proposal for the Antiterrorism Fund described above would guarantee each port a certain share of the funds. In contrast, we recommend that both the port and transit security programs be established as competitive grant programs. Rather

than guaranteeing grant amounts, OES should evaluate applications on a competitive basis to ensure that the projects chosen are those that improve the state's overall security to the greatest extent possible.

- ***Leveraging Other Funds.*** The measure does not specify whether local matching funds are expected as a condition of grants. We recommend that the Legislature establish local matching requirements for the programs. This would ensure that the grant recipients have a vested interest in making cost-effective spending decisions. In addition, the Legislature should require OES to review applications for commitments of ongoing operations costs. For instance, it would not be a good state investment to fund the purchase of surveillance equipment if there is no guarantee that the recipient will have the resources to use the equipment daily to monitor activities. Finally, the grant applications should be reviewed to make sure projects are coordinated with federal funds that are available for similar purposes.

Recommended Funding Approach. Once the Legislature develops the statutory framework for these programs, the budget bill should be amended to include program appropriations. Since these programs are new, we recommend that the Legislature commit only a portion of the funds in 2007-08. This would give the Legislature the opportunity to review the program's operations and make any necessary changes prior to committing additional funds.

OTHER SPENDING PROPOSALS

Open-Ended Request Lacks Specificity

We recommend that the Legislature reject a proposal for open-ended spending authority for public-private partnerships on emergency preparedness. Once it begins to receive donations for this purpose, the administration should present a specific spending proposal. (Delete Item 0690-001-8039.)

Legislature Authorizes Public-Private Collaborations. Chapter 232, Statutes of 2005 (SB 546, Dutton), specifically authorizes OES to collaborate with private entities to improve the state's emergency preparedness. Chapter 232 provides broad direction as to the types of activities that OES may undertake, including conducting outreach to businesses and developing information sharing systems for use during disasters. Chapter 232 creates the Disaster Resistant Communities Account to receive any private donations to help implement the bill's purpose.

Administration Requests Expenditure Authority. The Governor's budget requests a $1 million appropriation from the Disaster Resistant Communities Account. The proposal states that the $1 million would be for contracts with private entities to promote the purposes of Chapter 232. In addition, proposed budget bill language would allow this appropriation to be increased by the Department of Finance at any time if additional funds are received.

No Funds, No Plan. Despite seeking the appropriation, OES reports that it has collected no donations to the account. In addition, the department could not provide a plan for how the funds would be spent even if received. Instead, OES reports that a working group of state entities, private companies, and nonprofit organizations currently is developing some spending options.

Recommend Rejecting Appropriation Until Plan Is Developed. The state has not received any private funds for Chapter 232, and the administration has no plan as to how the funds would be spent once received. By approving the administration's request, the Legislature would be writing a blank check to OES to spend any monies received on a wide array of possible activities. Instead, we recommend that the Legislature reject the request. Once donations are received, the administration should seek an appropriation based on a specific spending plan.

Consulting Costs Unnecessary

We recommend that the Legislature delete $1.1 million in General Fund requests for consulting contracts to prepare various reports and perform other tasks. Departmental staff should be able to perform the work without these added costs. (Reduce Item 0690-001-0001 by $1,075,000.)

Requested Funding to Implement Legislation. The department requests $1.9 million from the General Fund and 7.3 personnel-years to assist the department in implementing six bills that were passed by the Legislature in 2006 aimed at improving the state's disaster preparedness. The requested staff would coordinate information and planning with various nonstate entities such as harbors, railroads, and the disabled community.

Consulting Services. Of the amounts in the proposals, $1.1 million is for external consulting services. Specifically:

- $600,000 to prepare a biennial report for the California Emergency Council required by Chapter 502, Statutes of 2006 (AB 1889, Nava). The council is an advisory board, staffed by OES, that advises the Governor on issues related to emergencies and emergency preparedness. The report is to include a review of recent disasters and steps to address any gaps in readiness.

- $250,000 to prepare a report for the Legislature by January 1, 2009, on improving planning and evacuation procedures specific to disabled residents required by Chapter 600, Statutes of 2006 (SB 1451, Kehoe).
- $225,000 to assist in implementing Chapter 859, Statues of 2006 (AB 2274, Karnette), which requires OES to integrate harbor agencies into the state's overall preparedness structure. The proposed contracts would be used for training exercises.

Legislature Did Not Expect Contract Costs. In last year's session, none of the bill analyses performed by legislative committees identified significant OES costs associated with these bills—generally citing costs as either insignificant or less than $125,000. For instance, in the case of Chapter 502, the analyses indicate the Legislature's expectation that OES's staffing of the Emergency Council is part of its baseline duties. While other analyses occasionally reference increased departmental staff work, none of them mention any costs associated with outside consultants.

Consultants Not Necessary. In addition, the consulting contracts have not been justified on a workload basis. Regarding Chapter 502, the department reports that the large contract is largely based on researching and reviewing other reports on emergency preparedness. Yet, in response to a requirement in the *2006-07 Budget Act*, OES has already entered into a $647,000 contract (using federal funds) with a consulting firm to provide a report on the gaps in the state's preparedness. This report is due by July 15, 2007, and should provide much of the baseline information for the council report. In the case of Chapter 600, it is not clear why the state emergency services coordinator position requested in the proposal would be unable to prepare the required report in 18 months by the statutory deadline. Finally, regarding Chapter 859, the proposal provides no detail regarding the training exercises, their cost, or why federal homeland security funds are not available for this purpose.

Recommend Deleting Contract Funds. The department has failed to justify why existing and new state staff could not prepare the reports and perform the duties required by recent legislation. Accordingly, we recommend the Legislature delete $1.1 million in contract funds included in its budget requests.

BOARD OF EQUALIZATION
(0860)

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

The *2007-08 Governor's Budget* proposes $390 million in support of BOE operations, of which $218 million is General Fund, with most of the remainder consisting of reimbursements from local governments. The proposed level of support represents an overall increase in funding of $6 million from the 2006-07 level and a net increase of $2 million General Fund. The number of personnel-years (PYs) for BOE is budgeted to increase slightly from 3,767 to 3,800.

Position Request Not Justified

We recommend the Legislature reduce the board's proposed position authority by six personnel years and $230,000 due to reduced workload in the electronic waste recycling program. (Reduce Item 0860-001-3065 by $230,000.)

Background. In 2004, the Legislature passed Chapter 863, Statutes of 2004 (SB 50, Sher), which states that, effective January 1, 2005, a consumer is required to pay an electronic waste recycling fee upon the purchase of a new or refurbished electronic device. The fee serves as a funding source for payment of collectors and recyclers of electronic waste in order to ensure the safe and environmentally sound disposal of these devices. The fee is administered by BOE, and remitted to the California Integrated Waste Management Board. To operate the program, the *2006-07 Budget Act* provided BOE $4,904,000 and 72.5 PYs. Of this staffing total, 27.7 were limited-term positions set to expire June 30, 2007.

Governor's Proposal. The budget proposes to eliminate 21.7 of the 27.7 limited-term positions, but extend for two more years the remaining six positions in order to administer the fee. The administration's proposal results in a staffing level of 50.8 PYs, a 30 percent reduction from the current year.

Position Request Not Justified. The board is anticipating a significant reduction in the number of accounts (that is, businesses involved with the fee) in the program in 2007-08. Based on our review of available workload information, it appears that the board would not need to extend the six limited-term positions for two more years.

Therefore, we recommend the Legislature reduce the board's proposed budget by six PYs and $230,000 (Electronic Waste Recovery and Recycling Account).

Revenue Estimate From Enforcement Work Scored Too Low

We recommend the Legislature score an additional $800,000 in General Fund revenues due to various enhancement to the board's Consumer Use Tax Section proposed by the administration.

Governor's Proposal. The administration proposes permanent status for six limited-term positions in the Consumer Use Tax Section at a cost of $313,000 ($203,000 General Fund and $110,000 reimbursements) in 2007-08. The administration estimates that the proposal would generate $4.3 million in additional General Fund revenues in the budget year.

Revenue Estimate Is Understated. The administration's revenue estimate reflects anticipated hiring delays and an estimated six-month training period for the staff to learn their job duties. However, staff for these six positions have already been hired and completed the training period. Thus, the BOE's estimate for revenues is too low. Based on our review, we recommend the Legislature score an additional $800,000 in General Fund revenues to be generated by the enhancements to the board's use tax program.

Electronic Filing Should Generate Savings

We: (1) withhold recommendation on the administration's request for two positions and $1,460,000 ($949,000 General Fund and $511,000 reimbursements) for electronic filing infrastructure enhancements, and (2) recommend that the Board of Equalization report at budget hearings regarding the status of efforts to develop a cost-savings model, together with estimates of medium- and long-term savings and costs associated with increased conversion to electronic systems.

Background. Previously, we have noted that BOE has been converting to electronic technologies in the filing of tax returns and remittances, as well as the processing of these returns. The advantages of shifting to electronic remittances and returns are significant. From the taxpayers' perspective, using electronic filing can minimize record keeping requirements, increase filing accuracy, and reduce costs. From tax agencies' perspective, electronic technologies decrease processing time, reduce storage costs, minimize personnel requirements, improve data accuracy, and facilitate sharing of information among the different agencies for enforcement and compliance purposes.

Electronic Processing Results in Savings. From a budgetary perspective, the costs associated with processing electronically filed returns and remittances are a fraction of the costs associated with paper documentation. For example, FTB has reported that about 4,800 electronic remittances are processed per staff hour. By comparison, only 62 paper remittances are processed per staff hour. This cost differential can translate directly into budget savings. In addition to processing savings, additional savings typically occur because the electronic submissions of remittances and returns are more accurate than their paper counterparts, thus requiring less follow-up contact with the taxpayer to correct inaccuracies.

Although BOE has made some progress in the electronic technologies and automation area, there are still substantial additional improvements that could be made. For instance, BOE just recently implemented electronic filing for single-location taxpayers (which account for a small proportion of total SUT liabilities), and has yet to offer electronic filing options for multiple-location taxpayers. Hence, while the agency receives about 60 percent of total SUT payments through electronic funds transfer, electronic tax filings represent only a small share of total tax returns.

Governor's Proposal. The administration is proposing additional funding and positions that would allow BOE to expand its SUT electronic filling program to include businesses filing multiple returns and others, as well as allow BOE to automate the delinquent prepayment process. To accomplish these goals, the administration requests two positions and $1,460,000 ($949,000 General Fund and $511,000 reimbursements) in

2007-08, and three positions and $431,000 ($280,000 General Fund and $151,000 reimbursements) in 2008-09.

No Savings Estimate Associated With this Proposal. The Governor's proposal represents stage three of a plan to move the agency and the taxpayers it serves towards a more electronically integrated business model. However, estimates of savings to the state associated with this electronic migration have yet to be quantified.

The administration's proposal indicates that savings associated with this proposal would be identified upon completion of BOE's Tax Return Processing Assessment, at which time the department would develop a cost-savings model that could be applied to the tax return processing areas affected by a reduction in paper return filings. The assessment was completed January 5, 2007, and although savings in either the medium- or long-term have yet to be identified, BOE indicates that it has begun work towards developing a cost-savings model.

We withhold recommendation on the administration's request for electronic filing infrastructure enhancements and recommend that the board report at budget hearings regarding the status of efforts to develop a cost-savings model, together with estimates of medium- and long-term savings and costs associated with increased conversion of existing registrations, tax filings, and manual processing to electronic systems. Without such information, it is difficult to evaluate and track program performance.

Tax Agency Information and Data Exchange

As discussed in the "General Government" cross-cutting issues section earlier, improved information and data exchange among the several state agencies that administer, collect, and enforce California's taxes would benefit the state. In that section, we summarize the findings of a report we recently prepared on this topic at the request of the Legislature and with inputs from the tax agencies involved. We also recommend that the tax agencies, including BOE, report at budget hearings on what actions they have undertaken or are planning to undertake in conjunction with our report's findings, and on other specified matters relating to tax-agency information and data exchange.

SECRETARY OF STATE
(0890)

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

The budget proposes total expenditures of $93 million for SOS in 2007-08. The two primary ongoing sources of funding are the General Fund ($36 million) and the Business Fees Fund ($37 million). In addition, the budget proposes spending $11 million in federal funds for the implementation of the Help America Vote Act (HAVA) of 2002. We discuss the implementation of HAVA below.

CONTINUED HAVA IMPLEMENTATION

Background

HAVA Requirements. In October 2002, Congress passed and the President signed HAVA. As the state's chief elections officer, the SOS is charged with administering the state's compliance with HAVA. Recent federal budgets have provided California with more than $350 million to implement HAVA requirements. The HAVA contains a number of specific requirements for states and counties related to election procedures. Among these requirements are:

- ***Replacement of Punch-Card Machines.*** Counties were required to replace their punch-card voting machines in favor of more modern technology in time for the June 2006 primary election.

- ***Statewide Voter Registration Database.*** The state was required to have in place by January 1, 2006, a computerized statewide database of voter registrations. Each voter must have a unique identification number. The database must be accessible to county election officials. In addition, the database must coordinate with three state agencies—the Department of Motor Vehicles (registrations from drivers' license applications), the Department of Health Services (death records), and the Department of Corrections and Rehabilitation (felons' voting status).

- ***Disabled Access.*** All precincts must have at least one voting machine that is accessible to the disabled.
- ***Voter Identification.*** Beginning in 2004, first-time voters who register by mail have to provide identification at some point in the voting process (either when registering or voting).
- ***Other Requirements.*** The HAVA also imposed new requirements relating to the handling of voters whose eligibility cannot immediately be determined (provisional ballots), voting by members of the military and overseas citizens, the handling of complaints, and the education of voters and poll workers. Generally, these requirements came into effect in 2004.

Audit Repayments

As a result of a federal audit of prior HAVA activities, the federal Elections Assistance Commission determined that the state misspent $2.9 million in HAVA funds. Of this amount, $536,000 was repaid directly to the federal government in 2006-07. Consistent with the audit findings, the Governor's budget proposes repaying the remaining $2.4 million in 2007-08 from the General Fund to the state's federal HAVA account (for additional elections-related spending).

HAVA Spending

Prior Spending. As shown in Figure 1 (see next page), the state has received HAVA resources totaling $371 million (including interest earned and repayments based on audit findings). In 2005-06 and earlier years, the state committed most of this amount—about $276 million. While most HAVA funding can be spent on a variety of HAVA-related activities, two pots of money were provided by the federal government for specific purposes—the replacement of punchcard voting machines and improving disabled access. These earmarked funds have been allocated to counties. The vast majority of the discretionary funds were also used to provide funding to counties. The largest such commitment was $195 million in grants to counties for the purchase of voting machines and associated education and training. (Although mostly encumbered by contracts with counties in 2005-06, actual payments to counties for allowable expenses has totaled about $63 million to date.)

Figure 1

Status of California's HAVA Funds

(In Millions)

Category	Total Funding	Spending Commitments: Prior to 2006-07	2006-07[a]	2007-08 and Future
Replacement of county voting machines	$57.3	$57.3	—	—
Disabled access	4.5	3.3	—[b]	$1.1
Discretionary HAVA funds[c]	309.3	214.9	$14.5	79.9
Totals	**$371.1**	**$275.5**	**$14.5**	**$81.0**

a Includes spending plan amendments pending at the time this analysis was prepared.

b Spending of less than $50,000.

c Includes estimated interest earnings and audit repayment from the General Fund.

2006-07 Spending Plan. On April 11, 2006, the SOS submitted a spending plan for the remaining funds available at that time. The Legislature approved that plan as part of the *2006-07 Budget Act* and added authorization for $760,000 for the review of the source code associated with electronic voting machines. A total of $6.3 million was appropriated for expenditure in the *2006-07 Budget Act*, with an additional $8.2 million in current-year spending pending at the time this analysis was prepared (primarily related to the rolling over of funds originally scheduled to be spent in 2005-06).

2007-08 Revised Spending Plan. Under the April spending plan, the continued implementation of the statewide database was the only scheduled activity for 2007-08. The SOS has proposed a number of additional activities to occur in the budget year. Under the revised plan, as shown in Figure 2, the following activities would be funded in 2007-08 at a total cost of $10.7 million.

- ***Statewide Database.*** The state's approach for a statewide database was approved in a memorandum of agreement with the United States Department of Justice. That agreement required the state to make interim upgrades to the state's existing CalVoter database

Figure 2

Revised HAVA Spending Plan Is Proposed

(In Thousands)

	2006-07	2007-08	Future Years
County voting equipment grants	$7,758[a]	—	—
Statewide database	3,099[a]	$7,095	$60,168
Administration	1,745	1,963	—
Source code review	760	—	—
Voter education	500	500	—
Parallel monitoring	342	—	—
Voting standards	150	—	1,748
Poll monitoring	65	—	—
Disabled access	41[a]	1,115	—
Unallocated reserve	—	—	8,651
Totals	**$14,460**	**$10,673**	**$70,567**

[a] Spending authorization for equipment grants, disabled access, and a portion of the database costs was pending at the time this analysis was prepared.

while working towards a new system. The interim upgrades are nearly complete, and the SOS is currently developing a proposal to seek vendors to implement the new database. The approved schedule calls for that proposal to be released soon. About $7 million will have been spent on the project (including the interim upgrades) by the start of the budget year, and an additional $7 million is proposed to be spent in 2007-08. Most of the project costs, however, will occur in future years once a primary vendor is selected. Costs beyond 2007-08 are currently estimated at $60 million. This amount is scheduled to cover the project through its first year of operations, but the General Fund will likely be required to cover the $10 million in annual operating costs beginning in 2011-12.

- ***Administrative Costs.*** The SOS requests $2 million for its HAVA staff and associated administrative expenses. In prior years, administrative costs have been funded at $1.7 million annually.
- ***Voter Education.*** The plan allocates $500,000 for 2007-08 to educate voters regarding HAVA requirements through the SOS Web site, newspaper advertisements, and pamphlets. Similar activities are also funded in the current-year budget.

- ***Disabled Access.*** The state has received an additional $1.1 million in restricted grant funds from the federal government to improve disabled access at polling places. The SOS proposes to distribute these funds to counties through competitive grant applications.

As shown in Figure 2, the spending plan reserves $8.7 million for future uses. In particular, the reserve was established to help defray any database cost overruns.

Progress Report on Source Code Review

We recommend that the Secretary of State's office present an update at budget hearings on the $760,000 in source code review funds. The prior administration did not spend any of the funds in the current year.

Source Code Review Was Legislative Priority. As noted above, the Legislature amended the April 2006 spending plan to include $760,000 for SOS to perform reviews of electronic voting machines' underlying code. With these funds, the Legislature intended to conduct additional testing to ensure that the machines accurately record voters' choices. As of January 16, 2007, the department reports that no HAVA funds were spent for source code review under the prior SOS administration this year.

Recommend Update. We recommend that the new SOS administration provide an update during spring budget hearings on the funds. Specifically, the SOS should specify how it intends to undertake source code review and whether the funds will be spent in the current year.

Begin Ramping Down Administration Costs

We recommend a reduction of $308,000 in administrative expenses to reflect the reduction in Help America Vote Act-related activities in the budget year. (Reduce Item 0890-001-0890 by $308,000).

Most HAVA Requirements Implemented. The revised spending plan proposes the continuation of the 10 personnel-years (PYs) provided in the current year. As described above, most HAVA requirements were implemented in time for the 2004 or 2006 elections. The two major tasks remaining for 2007-08 are implementing the statewide database and closing out the grants to counties. The database budget contains additional administrative and staff costs necessary for the implementation of the system.

Recommend Reduced Administrative Costs. We recognize that there are still some HAVA issues that will need to be resolved in 2007-08. The majority of the work, however, will have been completed by the start of the new fiscal year. Accordingly, we recommend that the Legislature reduce the HAVA administrative budget to reflect the slowing down of workload. Specifically, we recommend a reduction of 2.5 PYs concentrated in legal, media, and contract preparation work—for a savings of $308,000. The other 7.5 PYs should be sufficient to close out the remaining workload other than the ongoing database project. As a result, there should be no need for any administrative positions in 2008-09. Our recommended reduction would increase the HAVA reserve by a commensurate amount—making it available for any database cost increases or future operating costs.

DEPARTMENT OF CONSUMER AFFAIRS (1110-1111)

The Department of Consumer Affairs (DCA) is responsible for promoting consumer protection while supporting a fair and competitive marketplace. The department includes 27 semiautonomous regulatory boards, commissions, and committees that regulate various professions. These boards are comprised of appointed consumer and industry representatives. In addition, the department has 13 bureaus and programs that regulate additional professions which are statutorily under its direct control.

Expenditures for the support of the department and its constituent boards are proposed to total $447 million in 2007-08, an increase of $32 million, or 8 percent, compared to the current year. Several proposals contribute to this overall increase, the largest being $12 million to incorporate a "visible smoke test" into the Smog Check program pursuant to Chapter 761, Statutes of 2006 (AB 1870, Lieber). The activities of DCA are fully supported by fees collected from the various regulated professions that fall under its jurisdiction.

Reform of the Bureau of Private Postsecondary and Vocational Education

The Governor's budget requests funding and positions to reauthorize and restructure the Bureau of Private Postsecondary and Vocational Education. We withhold recommendation on the request pending receipt and review of the proposed legislation.

Background. The Bureau of Private Postsecondary and Vocational Education (BPPVE) is responsible for enforcing the Private Postsecondary and Vocational Education Reform Act, which regulates the state's private colleges and universities. The act is scheduled to sunset on July 1, 2007. Unless legislation is enacted to extend the act, the bureau will cease to exist on that date.

The bureau and its predecessor agencies have been subject to considerable criticism over the past decade. Various studies of the BPPVE have been carried out by private consulting firms, the Bureau of State Audits, the California Postsecondary Education Commission, and others. These studies have identified numerous problems with enforcement of the act, including inadequate oversight, large backlogs of licensing applications, underfunding of student tuition reimbursements, lack of responsiveness to student complaints, mismanagement, and others.

Last session, a bill (AB 2810, Liu) was introduced to (1) extend the sunset date for one year, and (2) establish a working group to review the reform act itself, as well as the various audits and performance reviews of BPPVE, and develop a legislative proposal to improve state oversight and promote quality private postsecondary education in California. The bill was passed by the Legislature and vetoed by the Governor.

Subsequent to the veto, a working group of legislative staff has been working to develop a new approach for regulation of the private postsecondary sector. In January 2007, the group developed a rough outline of features for a new California Private Postsecondary Act which, among other things, would create a new 7-member board within DCA as a successor to BPPVE.

Budget Request. The administration proposes to reauthorize BPPVE through legislation that also would make various changes to existing provisions. To that end, the Governor's budget requests $11.4 million and 75 positions to continue, as well as expand, the operations of BPPVE. This represents an increase of $3 million (36 percent), and 20 positions (37 percent) over the current-year levels. The additional revenue presumably would come from increased fees charged to regulated institutions.

Withhold Pending Receipt and Review of Additional Information. The department did not provide a workload analysis or other information to justify the requested positions. Moreover, at the time this analysis was prepared, the administration had not provided a complete legislative proposal. (In late January, it did provide a two-page conceptual summary of its proposal.) At this point, the Legislature does not have enough information to evaluate the proposed levels of funding and positions. Consequently, we withhold recommendation on the request, pending receipt and review of the proposed legislation, and associated workload analysis.

We would also note that, depending on the timing of the enactment of legislation to reauthorize the program, there may be as much as a six-month lapse in the operations of the bureau. However, the budget proposes full-year funding. Should the Legislature reauthorize the act, it may be necessary to adjust the funding to reflect the actual period of operation.

Franchise Tax Board
(1730)

The Franchise Tax Board (FTB) is one of the state's two major tax collection agencies. The FTB's primary responsibility is to administer corporation tax (CT) programs and—with the assistance of the Employment Development Department—California's personal income tax (PIT). The FTB also administers the Homeowners' and Renters' Assistance Programs. In addition, FTB administers several nontax-related programs, including the collection of child support payments and other court-ordered payments. The FTB is governed by a three-member board, consisting of the Director of Finance, the Chair of the Board of Equalization, and the State Controller. An executive officer, appointed by the board, administers the daily operations and functions of FTB.

The Governor's budget proposes $623 million ($518 million General Fund) and 5,175 positions in support of FTB's operations. Compared to the current-year budget, this represents a decrease of $140 million (18.3 percent) and a General Fund decrease of $44 million. The decrease from the General Fund is due almost entirely to reduced support of $39.2 million for the California Child Support Automation System.

The budget proposes increases for several initiatives to close the state's tax gap ($19.6 million General Fund), ongoing activities associated with court-ordered debt collection programs ($2 million in special funds), investment in e-commerce portal infrastructure ($1.5 million General Fund), additional legal support for abusive tax shelter workloads ($1.3 million General Fund), and a telephone customer service augmentation ($1.3 million General Fund). These increases are partially offset by decreases due to one-time cost reductions, expiring programs, and lease-revenue bond debt-service adjustments.

NARROWING THE TAX GAP

Background

There is a substantial difference between the amount of taxes that are statutorily owed to the state and the taxes that are actually remitted by taxpayers. This difference between owed and voluntarily remitted taxes is known as the "tax gap." Using federal estimates and state sources of information, the FTB has pegged California's tax gap associated with the PIT and CT at $6.5 billion annually.

Multipronged but Targeted Enforcement Approach Needed. The FTB and federal officials indicate that the tax gap is most associated with certain types of activities, taxpayers, and occupations—suggesting that particular targeted efforts should be made to best address the gap and limit the associated revenue losses. More than two-thirds of the gap results from underreporting of income (such as failure to report "off-the-books" income), while the remainder of the gap can be attributed to underpayment of taxes (including unwarranted claiming of tax credits) and nonfiling by those with California income. In terms of administrative issues, the existence of the tax gap is highly correlated to both the absence of tax withholding (such withholding currently occurs with respect to wages and certain other income) and the absence of third-party reporting (two major categories of such reporting include interest and dividends paid by financial organizations).

Recent Pilot Programs. The FTB has been pursuing various areas of tax noncompliance. For example, as part of the *2005-06 Budget Act*, the Legislature approved six two-year pilot programs (at a cost of $13.6 million and 175.5 positions), which expanded FTB's ongoing efforts in the following areas: (1) detecting preparers filing fraudulent returns with fictitious refundable credits, (2) developing additional information to detect PIT nonfilers, (3) conducting underground economy criminal investigations, (4) pursuing audit cases down to a four-to-one benefit-cost ratio (BCR), (5) targeting collection enforcement activities down to a three-to-one BCR, and (6) engaging in discovery audit activities to enhance the department's ability to detect underreporters. The pilot programs were successful at bringing in $56.3 million of additional General Fund revenue in 2005-06, an increase of $4.5 million over the original estimates. The 2007-08 budget proposes to make these pilot programs permanent. The FTB projects that these programs will produce $64.7 million in revenue at a cost of $13.6 million and 180.5 positions in 2007-08. The BCRs for these continuing initiatives are shown in Figure 1 (see next page).

Figure 1

Tax Gap: Continuing Initiatives

Program	Average Benefit/ Cost Ratio[a]
Detection of preparers filing fraudulent returns	5.8
Additional information sources to identify nonfilers	11.5
Underground economy criminal investigations	2.2
Audit staff augmentation	4.8
Collections staff augmentation	5.2
Discovery audit activities	1.5

[a] When programs are fully implemented.

Governor's 2007-08 Proposal

The administration proposes four new tax gap initiatives for the budget year. These proposals would add 49.5 positions, at a General Fund cost of $6 million. As Figure 2 shows, the four new initiatives are projected to generate $12.8 million in additional revenue in 2007-08, tripling to almost $40 million by 2009-10.

Figure 2

Tax Gap: New Initiatives

(Dollars in Thousands)

	2007-08 Costs		Revenues			Average Benefit/ Cost Ratio
Program	Positions	Costs	2007-08	2008-09	2009-10	2009-10
Independent contractors	6.0	$581	$1,500	$5,900	$5,900	10.2
Corporate nonfilers	7.5	1,276	900	4,000	8,400	6.6
Out-of-state tax avoidance	23.0	2,324	10,400	16,800	16,800	7.2
Investigations	13.0	1,841	—	—	13,000	7.1
Totals	**49.5**	**$6,022**	**$12,800**	**$26,700**	**$44,100**	**7.8**

The four programs would:

- ***Focus on Independent Contractors.*** This proposal targets independent contractors who do not fully report income or who deduct more than allowable expenses on their tax returns. (The FTB estimates that approximately $3.5 billion of the state's tax gap is attributable to sole proprietors, many of whom are independent contractors.) The proposal would fund six new positions at a cost of $581,000 in 2007-08. The funds would be used both for education and outreach, and increased audits of noncompliant taxpayers. The FTB estimates the program would raise $1.5 million in 2007-08, increasing to $5.9 million in 2008-09.

- ***Expand the Corporate Nonfiler Program.*** This proposal focuses on noncompliance of certain business-entity nonfilers by augmenting FTB's Integrated NonFiler Compliance System. The funds would allow FTB to access more data sources to identify business nonfilers. Additional data sources include federal 1099 and 1098 tax forms and various California business-related tax forms. (The FTB estimates that approximately 5,900 additional nonfilers could be identified if these data sources were available.) The proposal would fund 7.5 new positions at a cost of $1.3 million in 2007-08. The FTB estimates the program would raise an estimated $900,000 in 2007-08, increasing to $8.4 million in 2009-10.

- ***Address Out-of-State Tax Avoidance.*** This proposal targets out-of-state taxpayers who intentionally avoid California income taxes. In particular, it would focus on taxpayers who use a series of transactions often referred to as tax schemes (including sham corporations), promoters of tax schemes, California residents filing as nonresidents, and noncompliance in the entertainment industry. Additionally, the proposal would enable FTB to identify and pursue those individuals who promote tax schemes and assess penalties for tax avoidance where appropriate. Finally, this measure would provide expanded education and outreach programs for tax practitioners and others who deal with out-of-state taxpayers. The proposal would fund 23 new positions, at a cost of $2.3 million in 2007-08. The FTB estimates it would raise $10.4 million in 2007-08, increasing to $16.8 million in 2008-09.

- ***Expand Investigation Workloads.*** This proposal expands identification, investigation, and prosecution of taxpayers who fail to file a return or who submit a false return to the state. (Based on historical modeling and future projections, FTB investigations staff have identified 148 additional cases that could be opened immediately, involving more than $98 million in unreported income.) The proposal would fund 13 new positions at a cost of $1.8 million in 2007-08. The FTB estimates that resulting increases in voluntary compliance would raise $13 million in annual revenue beginning in 2009-10.

Recommend Reallocation of Tax Gap Efforts

We recommend that the Legislature redirect some proposed budget-year spending on tax gap enforcement activities in order to increase their payoff in terms of General Fund revenues.

Given the large tax gap, we believe the administration's proposal to commit additional resources toward this problem is appropriate. It is, however, important to invest state resources where returns are greatest. Below, we identify areas in both the continuing and new tax gap programs where the state could get a bigger revenue bang for its enforcement buck.

Continuing Initiatives. With regard to the continuing initiatives, several programs that are funded would produce BCRs at or below 5:1, including (1) expansion of underground economy criminal investigations, and (2) augmentations to collections staff. We recommend instead that $3 million allocated to these programs be redirected to the identification of nonfilers. The FTB indicates this initiative will have a BCR of 11.5:1 when fully implemented. (We do not recommend shifting resources away from the discovery audit program because investment in this program can improve audit selection.)

New Initiatives. Similarly, revenues associated with proposed investigations are based on increased voluntary compliance due to media coverage of these cases. As such, these revenues are much more speculative than revenues expected from other programs. Consequently, we recommend that $600,000 be redirected from the investigations staffing to the program targeting corporate nonfilers.

We also recommend two other changes to the budget's new proposals. First, the request reflects a shift in approach towards what FTB describes as "softer" tax gap efforts—including a focus on taxpayer education and direct outreach activities. While we agree that taxpayer education is important, we believe that tax gap efforts should be principally enforcement based. Accordingly, we recommend that the resources proposed for some of the new initiatives be reallocated to achieve greater benefit to the state's General Fund. Specifically, the initiative targeting independent contractors would expend roughly one-half of the resources on education and outreach. We recommend instead that these types of expenses be limited to no more than 25 percent of the staffing request.

Second, the administration's initiative targeting out-of-state tax avoidance includes a feature which would forego penalties even if an audit is completed and noncompliance identified. Penalties are assessed to both serve as a deterrent of future noncompliance and to recoup some of the audit costs from those noncompliant taxpayers. As such, we recommend that the board continue to assess the appropriate penalties when noncompliance is uncovered as a result of an audit.

Figure 3 shows our recommended allocation of resources among tax gap programs as compared to the administration's proposal.

Figure 3

LAO Recommended Adjustments to Tax Gap Proposals[a]

(Dollars in Thousands)

	Governor's Budget		LAO	
Initiatives	**Positions**	**Costs**	**Positions**	**Costs**
Continuing				
Additional information sources to identify nonfilers	17.0	$1,481	57.5	$4,448
Underground economy criminal investigations	19.0	1,857	3.8	457
Collections staff augmentation	55.0	3,364	29.7	1,797
New				
Independent contractors[b]	6.0	$581	6.0	$581
Corporate nonfilers	7.5	1,276	15.0	1,876
Investigations	13.0	1,841	8.8	1,241
Totals	**177.0**	**$15,222**	**180.3**	**$15,222**

a Only those initiatives where we recommend changes are shown.

b While there is no dollar difference, LAO's proposal would redirect more funding to audit activity and less to education and outreach.

Impact of LAO Recommendations. If the Legislature adopted our recommended changes to the proposed tax gap initiatives, the board would still be spending the same overall amount on these activities as proposed in the budget. We believe, however, that our approach would generate considerably more revenue to the General Fund, potentially in the tens of millions of dollars annually.

E-Services Save Time and Money

We recommend that the Franchise Tax Board's (FTB's) budget be reduced to account for savings associated with increased use of business entity electronic return processing, electronic remittance processing, and associated reductions in the amount of paper printing and mailings. (Reduce Item 1730-001-0001 by $500,000.)

The FTB has made considerable strides in electronic remittance and return processing. The costs associated with processing electronically filed returns and remittances are a fraction of the costs associated with paper documentation. For example, FTB has reported that about 4,800 electronic remittances are processed per staff hour. By comparison, only 62 paper remittances are processed per staff hour. This cost differential should translate directly into budget savings.

Information provided by FTB indicates ongoing growth in electronic filing of returns and remittances. This growth has occurred as a combined result of statutory mandates for tax practitioners as well as a natural migration from paper to electronic filing by individual and business taxpayers as society becomes increasingly computer oriented. The department reports that it expects 9 percent annual growth in electronic remittances through 2008, and 4 percent to 7 percent annual growth in electronic returns over the same period.

Reflecting the growth in electronic filings and remittances—and the large savings associated with the use of this technology—the department's budget has been reduced almost every year since 2001-02. These annual reductions ranged from $400,000 to about $1 million.

The 2007-08 budget includes savings of $298,000 due to increased PIT electronic filing. However, no budget reductions were proposed related to increased electronic remittance processing or reductions in mailed and printed tax forms and booklets due to more use of online forms and other information. The board is also expanding the Business Entities E-File (BEEF) system, but did not account for any savings associated with increased electronic filing of BEEF returns.

LAO Recommendation. Based on information provided by the department, we recommend that the Legislature reduce FTB's budget by $500,000 for 2007-08 to account for savings associated with increased use of business-entity electronic return processing, electronic remittance processing, and associated reductions in the amount of paper printing and mailings.

Customer Service Level Deficiency Is Seasonal

We recommend that the Legislature reduce the augmentation for the Franchise Tax Board's Contact Centers by $724,000 (General Fund) because it does not provide adequate justification for the higher permanent staffing level. (Reduce Item 1730-001-0001 by $724,000.)

Background. The FTB provides taxpayers with several ways to access tax-related information. One such mechanism is its Taxpayer and Tax

Practitioner Contact Center, which provides assistance to taxpayers with general information on tax laws, filing requirements, return preparation, forms requests, and other services. Calls to the Contact Center are first answered by the department's Integrated Voice Response (IVR) system, which is an interactive system that uses prompts and keyed-in responses from the taxpayer to provide tax-related information and services. These include (1) providing refund status, payment, balance due, and other account information; (2) ordering forms; and (3) answering frequently asked tax-related questions. Prompts from the IVR system are available in both English and Spanish for both PIT and CT filers, and 100 percent of all calls are answered immediately by the IVR system. Taxpayers who indicate that they do not want to interact with the IVR system are then routed to personnel in the Contact Center. Several budget reductions in the past few years have reduced staffing levels in the center by roughly 80 positions (approximately 28 percent).

Governor's Budget Proposes to Partially Restore Staffing Levels. This proposal requests funding of $1.3 million (General Fund) and 27 permanent positions to partially restore staffing levels in the Contact Center.

Governor's Proposal Lacks Justification for Permanent Staffing. On a month-to-month basis, Contact Center personnel respond to 83 percent of all calls routed by IVR—excluding the high-volume call times of May through August. However, during these four high-volume months, the center responds to just 50 percent of callers. (The other half never actually speak with a live agent—some hang up while waiting for a live agent to become available, while others are not able to get in the queue for a live agent due to high-call volumes). We agree that additional support to the department in conjunction with these high-volume months would be appropriate. However, we find that the administration's proposal to add 27 full-time staff overstates their need. Rather, to reduce wait times on calls and improve taxpayer access during the busy months, we recommend that the Legislature authorize the equivalent of 35 positions for the high-volume call period. (The board could use either permanent intermittent staff or temporary help during this time.) This approach would result in savings of $724,000 (General Fund) relative to the budget proposal.

Delete Augmentation of Legal Support for Abusive Tax Shelters

We recommend that the Legislature delete $1,330,000 and ten positions from the budget's request to provide additional legal support for Abusive Tax Shelter workloads as the Franchise Tax Board has not

adequately justified the staffing increase. (Reduce Item 1730-001-0001 by $1,330,000.)

Background. In recent years, the prevalence of illegal or "abusive" tax shelters (ATSs) has increased dramatically, resulting in substantial revenue losses in California. In an effort to curb ATS activity, the Legislature enacted Chapter 654, Statutes of 2003 (AB 1601, Frommer), and Chapter 656, Statutes of 2003 (SB 614, Cedillo). This legislation established a number of programs to penalize the use of ATSs and to discourage their further use. The statutes (1) provided for a limited amnesty for participants in certain ATSs through a Voluntary Compliance Initiative (VCI), (2) created new ATS-related penalties and reporting requirements, and (3) expanded the state's ability to take legal action against ATS participants.

The VCI was implemented to provide taxpayers who participated in an ATS an opportunity to voluntarily amend their tax returns before harsher penalties became effective. To support the VCI, seven legal positions were dedicated to the department's ATS task force. Subsequently, in 2006, FTB reclassified seven audit positions into seven legal-related positions, bringing total legal ATS resources to 14 positions.

Governor's Budget Proposal. The budget requests an augmentation of $1.3 million (General Fund) and ten legal positions for the ATS program. The budget maintains that the positions are needed to assure that the state will generate the level of ATS-related audit revenues already assumed in the budget.

Concerns With the Proposal. As we have noted in the past, ATS transactions can be incredibly complex. As such, it is important for the board to have adequate legal support for its enforcement efforts. The budget request, however, would result in a more than tripling of ATS-related legal staff from the level authorized in the *2006-07 Budget Act.* As noted above, the board doubled its ATS-related legal staff in the fall of 2006 by reclassifying seven auditors to attorneys. Given the short amount of time these additional resources have been in place, it is too soon to evaluate the benefits of these existing ATS legal positions—let alone assess the worth of ten additional positions. Therefore, we recommend the Legislature delete the proposed augmentations of ten positions, for a savings of $1,330,000 (General Fund). This would give FTB time to develop better information on the relative benefits of adding ATS-related legal staff versus other compliance positions (such as auditors).

TAX AGENCY INFORMATION AND DATA EXCHANGE

As discussed in the "General Government" "Crosscutting Issues" section earlier, improved information and data exchange among the several state agencies that administer, collect, and enforce California's taxes would benefit the state. In that section, we summarize the findings of a report we recently prepared on this topic at the request of the Legislature and with inputs from the tax agencies involved. We also recommend that the tax agencies, including FTB, report at budget hearings on what actions they have undertaken or are planning to undertake in conjunction with our report's findings, and on other specified matters relating to tax-agency information and data exchange.

Department of General Services (1760)

The Department of General Services (DGS) is responsible for providing a broad range of services to state departments, and providing management and oversight activities related to these services. It provides these services through three programs: statewide support, building regulation, and real estate services. The DGS is a fee-for-service entity in which the bulk of its expenditures are reimbursed from other departments as services are provided.

The Governor's budget proposes total expenditures of $1.2 billion from various funds (including $9 million from the General Fund) to support DGS activities in 2007-08. The General Fund expenditures are almost entirely for repairs to the Capitol building. Expenditures for building regulation and statewide support services are $736 million in the budget year, an increase of $78 million, or almost 12 percent above estimated current-year expenditures. Real estate services accounts for an additional $416 million. This represents an increase of $31 million (8 percent) over last year, with about one-half of the increase ($14 million) attributable to the inclusion of the Secretary of State's building into the DGS real estate portfolio.

Awaiting Report on the California Highway Patrol (CHP) Enhanced Radio System

We withhold recommendation on a proposed expenditure authority increase of $4.9 million for costs associated with the California Highway Patrol Enhanced Radio System pending the delivery of a March 1 annual report.

Background. In 2006-07, the Legislature approved the first stage of CHP's proposed replacement of its aging communications system. As part of this project, DGS will provide telecommunications systems design and real estate services. The 2006-07 budget for CHP includes $57 million for the project and requires CHP to submit a report to the Legislature annually on March 1 with revised estimates of total project costs, including DGS costs.

Budget Request. The budget proposes DGS spending of $4.9 million from the Service Revolving Fund to continue work on the radio system. The request includes $1.1 million for 14 telecommunication technicians, and $3.8 million for operating expenses and equipment, primarily for telecommunication equipment. Prior to receipt of the annual report, there is little information upon which to determine if the funds requested are reasonable and consistent with CHP's current schedule and costs.

Withhold Recommendation Pending Report. We withhold recommendation on the DGS funding pending delivery and review of the required annual report from CHP. The report will allow the Legislature to determine if the project is on schedule and budget prior to committing additional funding.

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM (1920)

Under the direction of the Teachers' Retirement Board (TRB), the California State Teachers' Retirement System (CalSTRS) administers pension and other benefits for 776,000 current and former educators of California's school and community college districts. In order to fund defined monthly benefits to eligible retired teachers, CalSTRS uses (1) returns generated from its $156 billion investment portfolio and (2) contributions made pursuant to state law by teachers, districts, and the state.

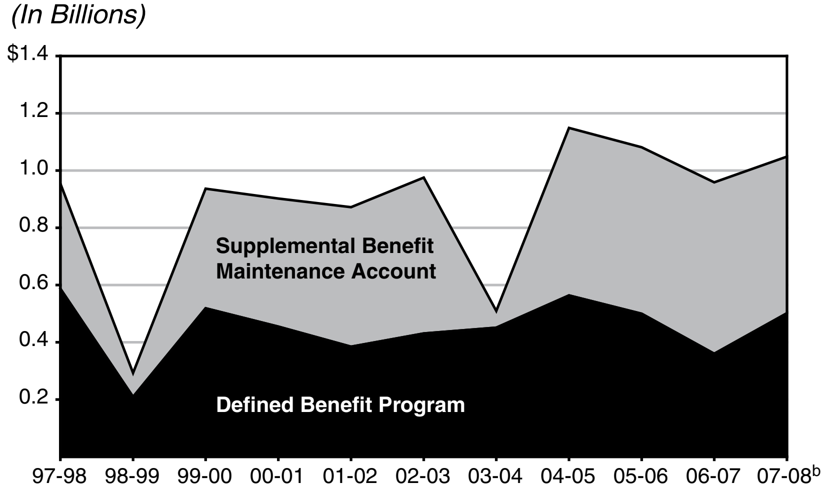
Under current law, the state must make two separate annual payments to CalSTRS from the General Fund:

- A payment equal to 2 percent of prior-year teacher payroll for CalSTRS' Defined Benefit (DB) Program, which funds the basic pension benefits for retired educators.
- A payment equal to 2.5 percent of prior-year teacher payroll for CalSTRS' Supplemental Benefit Maintenance Account (SBMA), which is also known as the "purchasing power account." Funds in SBMA prevent erosion of the purchasing power of retirees' benefits by the effects of inflation.

Figure 1 shows that the trend of the state's CalSTRS contributions in recent years has been volatile due largely to several prior legislative actions that have produced one-time state budget savings. The *2007-08 Governor's Budget* proposes $1 billion of state contributions to CalSTRS, 6.4 percent above those of 2006-07. (In 2006-07, contributions were reduced on a one-time basis due to prior accounting errors by CalSTRS.) The contributions in the Governor's budget include (1) $501 million for the DB Program—the required amount under current law—and (2) $547 million for SBMA. The proposed SBMA contribution is $75 million less than the 2.5 percent of prior-year teacher payroll that is required under current law. The administration proposes trailer bill language to authorize the lower amount of appropriations. We discuss this proposal later in this write-up.

Figure 1

State Contributions to CalSTRS[a]



[a] State contributions declined in 1998-99, 2003-04, and 2006-07 due to statutory actions in each year that generated one-time budget savings. Contribution rates for the Defined Benefit Program were adjusted pursuant to statutes in 1998 and 2000.

[b] Proposed.

System's Funded Status Is About Average for Comparable Pension Systems

The most recent California State Teachers' Retirement System actuarial valuation reported that the system's unfunded liability declined from $24 billion in 2004 to $20 billion in 2005. Measured as a percentage of the system's total liabilities, this unfunded liability is about average among comparable public pension systems. The Teachers' Retirement Board has formulated a general proposal for the Legislature's consideration, which would attempt to address the unfunded liability.

System Is 86 Percent Funded, With $20 Billion Unfunded Liability. The system's actuaries reported that, as of June 30, 2005, CalSTRS's unfunded actuarial obligation for its DB Program was $20 billion, and the actuarially determined value of DB Program assets on hand was $122 billion (the bulk of the system's assets). This means that the program is 86 percent funded, which is approximately the average reported funding level of major public pension systems nationwide. Figure 2 shows the value of assets and unfunded obligations (as well as the comparable funded status on a percentage basis) for some other large teacher retirement systems.

Figure 2

CalSTRS' Funded Status Is About Average

(Dollars in Billions[a])

Teacher Retirement Fund	Actuarial Asset Value	Unfunded Liability	Funded Status[b]
CalSTRS	**$122**	**$20**	**86%**
Texas	94	14	87
New York State	74	1	99
Ohio	54	20	73
Pennsylvania	52	5	91
Georgia	45	0	101
Michigan	39	8	84
Illinois	37	22	62
New Jersey	35	6	86
New York City	33	0	100
Weighted Average	**72**	**11**	**87**

a Data from most recent available actuarial reports. Actuarial cost methods, other methods, and assumptions used by the systems vary.

b Funded status equals actuarial asset value divided by the actuarially determined value of system liabilities.

Proposal to Address Liabilities Would Require Legislature's Approval. In recent months, the TRB has formulated a general proposal to address the unfunded liability. Among other provisions, the proposal would give TRB the authority to increase required contributions by teachers, districts, and the state. The Legislature must approve any such change in TRB's authority.

LAO Framework for the Future of CalSTRS. In our *Analysis of the 2005-06 Budget Bill*, we described the CalSTRS retirement plan for teachers, its funding, and its unfunded liability. We also suggested that comprehensive reform of CalSTRS should place decision making and responsibility for retirement issues at the local level with employers (school and community college districts) and employees (teachers). Virtually all public pension systems in the state, including most benefit programs of the California Public Employees' Retirement System (CalPERS), adhere to the general principle that retirement benefits should be established mainly through agreements between employers and employees and paid for by those groups. For CalSTRS, on the other hand, the state currently mandates the benefits provided by all employers and shares in the payments for those benefits. We believe that the key principles for any legislative overhaul of CalSTRS' funding structure should be: (1) increasing local control over the benefits provided, (2) providing districts with flexibility, and (3) defining clearly the local responsibilities for long-term funding of the system. We are currently reviewing the specifics of CalSTRS' new funding proposal.

State's Loss of Lawsuit Would Require Payment of Over $650 Million

If an appellate court rules against the administration's efforts to overturn a court ruling ordering the state to repay the $500 million withheld from the Supplemental Benefit Maintenance Account in 2003-04, the state may be required to transfer over $650 million (the withheld amount plus interest) from the General Fund to the California State Teachers' Retirement System. Should this payment be required, we recommend that the Legislature fund it from the General Fund reserve if possible. However, if the Legislature chooses to borrow funds to make the payment, it should consider options with the lowest overall interest costs.

Legislature Established SBMA to Improve Retirees' Purchasing Power. The standard annual benefit adjustment for retired teachers in CalSTRS is 2 percent per year. Unlike cost-of-living adjustments of CalPERS and many other public retirement systems, CalSTRS' annual adjustment is not compounded. (If, for example, a member received a $3,000 monthly benefit immediately after retirement, his or her annual 2 percent adjustment would increase the monthly benefit by $60 after one year, an additional $60 the next year, and so on.) Therefore, CalSTRS' annual adjustment may be insufficient to preserve the purchasing power of retirees' benefits (especially during periods of high inflation). In recognition of this, the Legislature has approved several measures to bolster the benefits' purchasing power. Since 1990, the Legislature has appropriated General Fund moneys to SBMA. The SBMA's funds are distributed to keep the purchasing power of all retirees' monthly benefit allowances at no less than a specified minimum percentage of the retiree's initial allowance at the time of retirement (based on growth of the California Consumer Price Index over time). In 2001, the Legislature provided that—to the extent funds were available in SBMA and other specified accounts—CalSTRS retirees' benefits would be adjusted annually to a level equal to 80 percent of the purchasing power of the initial allowance. Currently, 29 percent of CalSTRS' retirees receive benefit adjustments under this provision. The SBMA currently disburses about $260 million per year in such benefits. (This is a small amount compared to the DB Program's $6 billion in annual payments.)

State Law Specifies Annual SBMA Contribution Levels. State law provides for a continuous appropriation from the General Fund to SBMA of an annual amount equal to 2.5 percent of prior-year teacher payroll. The law states that it is the Legislature's intent that the continuous appropriation be a "contractually enforceable promise to make annual contributions" to SBMA. Chapter 6, Statutes of 2003 (SB 20x, Committee on Budget and Fiscal Review), decreased the statutory annual appropriation by $500 million in 2003-04 on a one-time basis to help address the state's budget deficit that year. Chapter 6 also provides for the state to contribute additional amounts to SBMA in certain instances if needed for the fund to make purchasing power benefit payments to retired teachers through June 30, 2036. The CalSTRS sued the state, claiming that Chapter 6 unconstitutionally violated the contractual rights of system members. In May 2005, a superior court ruled in favor of CalSTRS. The Department of Finance (DOF) appealed the ruling to an appellate court, which is likely to rule at some point during 2007. The superior court ordered the state to pay the $500 million to CalSTRS with 7 percent interest. The California Retired Teachers Association has appealed that part of the ruling to the appellate court, claiming that interest prior to the judgment date in the superior court should be awarded at a rate of 10 percent.

Recommend Legislature Use Reserves or Seek Low-Interest Borrowing Option. Should the appellate court and/or the California Supreme Court issue a final ruling against the state, we estimate that the state's payment obligations could be somewhere between $650 million and $800 million, depending on the date of the final court order and the interest rate set by the judges. The court may order the state to transfer funds immediately. If so, we recommend that the Legislature consider funding the payment from the General Fund reserve in order to avoid additional costs. Should such a large amount of reserves not be available, the Legislature may be able to borrow the funds. In this case, the Legislature should seek to minimize total interest costs by choosing a debt instrument with (1) a low interest rate and (2) a repayment term that is as short as possible.

Recommend Rejecting Plan to Guarantee Teacher Benefit

We recommend that the Legislature reject the administration's proposed trailer bill language to (1) guarantee teachers' purchasing power benefits through California State Teachers' Retirement System (CalSTRS) and (2) reduce General Fund costs by $75 million in 2007-08. There are risks in assuming that the change proposed in the budget package will generate near-term and ongoing budget savings, and we are concerned about the idea of the **state** ***guaranteeing another benefit through CalSTRS, which serves employees of*** **local** ***districts. We do***

suggest, however, that such a proposal in the context of a future comprehensive reform would warrant consideration by the Legislature.

Budget Proposes Changing Appropriation Language and Guaranteeing the Benefit. The Governor's budget proposes changing the annual SBMA appropriation amount in the law from 2.5 percent of prior-year teacher payroll to 2.2 percent. In addition, the administration proposes amending the law to guarantee CalSTRS members that they will receive the current SBMA benefit (80 percent of purchasing power). The effect of this proposal would be that CalSTRS' members would have a new contractual right to receive the 80 percent purchasing power benefit, no matter how well funded SBMA is. While the proposal would alter the contractually enforceable contribution amount in current law, courts have ruled that such changes may be allowed if a new benefit (such as the proposed benefit guarantee) is provided at the same time.

Administration's Actuary Suggested Proposed Contribution Rate. Because SBMA benefits are not guaranteed, CalSTRS historically has not performed valuations of SBMA similar to those used to identify the unfunded liability of the DB Program. In connection with the SBMA lawsuit discussed above, however, DOF hired an actuary to perform a standard actuarial analysis of SBMA's financial condition as of June 2003. Reporting that he used CalSTRS' standard actuarial assumptions, DOF's actuary found that SBMA had a $6.2 billion unfunded liability. Even so, he concluded that the current 2.5 percent annual contribution rate was "more than sufficient" to allow the fund to disburse promised benefits. The actuary found that, if the actuarial assumptions were accurate, SBMA's investment balances would grow significantly over the next 60 years to over $150 billion by 2050 and give the account the ability to fund benefits "indefinitely." In the opinion of the actuary, an annual state contribution of 2.2 percent of teacher payroll (instead of the current 2.5 percent contribution) would be sufficient to retire the unfunded liability within 30 years, assuming that the actuarial assumptions are accurate. The administration's proposed new contribution rate to SBMA relies on this actuarial analysis of the program as of 2003.

Recommended Rejecting Proposal. The proposal is intriguing in that it purports to reduce state costs, while simultaneously guaranteeing a benefit to teachers. Despite the possibility that the proposal could result in a near-term reduction of state costs, we recommend that the Legislature reject it at this time, for two principal reasons.

- ***Some Risks for the Projection of Savings.*** First, we note that under the State Constitution, public pension boards like TRB have "sole and exclusive power" over pension actuarial services. In recent decades, when the Legislature periodically has amended the law to adjust state contribution rates for CalSTRS, it usually has relied on CalSTRS' actuaries to suggest the appropriate long-term contribution level to be included in law based on actuarial assumptions in use at the time. Should CalSTRS' valuation of the contributions needed to fund the purchasing power benefit not match those of DOF's actuary, the proposed funding formula in the Governor's budget could be vulnerable to (1) legal challenge because it is insufficient to fund the benefit or (2) requirements for increased contributions in the future in order to keep the benefit fully funded. Regardless of what CalSTRS' actuaries say now, once the purchasing power benefit is guaranteed, the state could be obligated to make much higher contributions in the future if inflation increases SBMA costs or poor investment returns diminish the account's assets. Under current law, CalSTRS' members bear financial risk if these negative events occur. By contrast, under the budget proposal, the state's General Fund would bear the risk.

- ***Guaranteeing New Benefit Raises Concerns.*** Second, we believe that the Legislature should be skeptical of *any* proposal to guarantee a new retirement benefit for state employees or teachers at a time when state pension and retiree health programs—including CalSTRS—have unfunded liabilities approaching $100 billion. (The CalSTRS' current valuation of DB Program liabilities does not reflect the SBMA unfunded liability identified by the DOF actuary.) We are particularly concerned with the idea that the *state* would mandate another benefit in a CalSTRS retirement program that serves employees of *local* school and community college districts. Instead of decreasing state requirements, consistent with the framework for CalSTRS reform that we suggested in the *2005-06 Analysis*, the proposal would add one more obligation and move CalSTRS in the wrong direction.

Legislature May Wish to Consider Such a Proposal in the Context of Reform. While we recommend that the Legislature reject the proposal at this time, we can think of a scenario in the future when a similar proposal would warrant consideration. Specifically, should the Legislature wish to adopt significant changes in CalSTRS' funding structure in the future, we believe that it should use the opportunity to place control of the retirement program in the hands of local school and community college districts, rather than the state. A proposal to guarantee purchasing power benefits for current and past teachers would make more sense as part of an overall package that also gave districts more flexibility to determine benefit levels and funding requirements for their employees in CalSTRS.

DEPARTMENT OF CORPORATIONS (2180)

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

The budget proposes total expenditures of $34 million and 277 positions in 2007-08. This is $553,000, or 2 percent, more than estimated current-year expenditures. The increase is due to budget requests to address increased workload in the Broker/Dealer and Investment Advisers Program, and the Lender Fiduciary Program.

State Corporations Fund: Legislative Oversight Needed

We withhold recommendation on the department's budget pending a report at budget hearings because the department has not submitted a statutorily required report on its fees to the Legislature and the proposed fund balance in the State Corporations Fund exceeds the requirements of current law.

The DOC collects fees and assessments, as well as penalties and fines from the businesses it regulates. These revenues are deposited into the State Corporations Fund to support the activities of the department. Generally, revenues that are not required to support the department in a given year are maintained in the fund. This is referred to as the reserve or fund balance. In past years, due to an imbalance between revenues and expenditures, the State Corporations Fund experienced relatively large reserves. For example, on June 30, 2001, the fund had a reserve of $27 million, which represented 117 percent of its actual expenditures ($24 million) in 2000-01. As a general rule of thumb, we consider a 5 percent fund balance to be a prudent reserve.

Chapter 118, Statutes of 2001 (SB 742, Escutia), among other things, required DOC to reduce or suspend its fees to achieve no more than a 25 percent fund balance in the State Corporations Fund by June 30, 2007. The act also required the department to submit a report to the Legislature by November 1—each year from 2002 through 2007—providing a status update on the fees reduced, and the revenue and fund balance through the 2006-07 fiscal year.

DOC Not in Compliance With State Law. Our review indicates that the department has not complied with the requirements of Chapter 118. First, the budget proposes a 2006-07 fund balance of $15 million and a 2007-08 fund balance of about $11 million for the State Corporations Fund. This equates to 45 percent and 31 percent, respectively, of the total proposed expenditures for those years, rather than the 25 percent maximum allowed under current law. Second, the department has not provided the Legislature with the latest status report on its fees and fund balance as required. For these reasons, we withhold recommendation on the department's budget pending a report at budget hearings on how it proposes to meet the current law requirements in 2007-08. Specifically, the department should report on how it intends to reduce the fees to a level that complies with state law.

Absent a reduction in fees, the Legislature may wish to reduce the fund balance by transferring some of the 2006-07 carryover balance to the General Fund. For example, as in the past, the Legislature has required the department to transfer any fines and penalties it collects to the General Fund. In 2003-04, $45 million was transferred from the State Corporations Fund to the General Fund, and in 2004-05 (the last year in which there was a transfer) the amount transferred to the General Fund was $1.5 million.

Housing and Community Development (2240)

The mission of the Department of Housing and Community Development (HCD) is to help promote and expand housing opportunities for all Californians. As part of this mission, the department is responsible for administering a variety of housing finance, economic development, and rehabilitation programs. Some of the programs administered by the department, such as California Homebuyer's Downpayment Assistance, provide financial assistance so that low- and moderate-income families can purchase a home. While other programs, like Multifamily and Supportive Housing, provide assistance for the construction, rehabilitation, and preservation of permanent and transitional rental housing for low-income and disabled individuals and households. The department is also responsible for implementing and enforcing building standards. In addition, the department provides policy advice and statewide guidance on housing issues.

The budget proposes expenditures of $969 million for 2007-08. This represents an increase of $315 million (or 48 percent) over estimated current-year spending. The increase is mainly due to expenditures of bond funds authorized by Proposition 1C. The department has a proposed staffing level of 597 positions.

Designate Lead Department for New Program

The budget requests $685,000 and two positions for the department to implement a new Housing Urban-Suburban-and-Rural Parks program established by Proposition 1C. We recommend that instead of the Department of Housing and Community Development (HCD), the Department of Parks and Recreation (DPR) be designated as the primary administrator for the new program. This is because DPR has administered various park grant programs for many years, while HCD has only limited experience in park development and funding. Consolidating park grant programs in DPR would result in lower administrative

costs and better coordinated project selection. Accordingly, we recommend that the positions and support funding be rejected. (Reduce Item 2240-001-6071 by $685,000.)

We further recommend appropriating $30 million in Proposition 1C park funds to DPR instead of HCD for allocation to local parks projects. (Reduce Item 2240-101-6071 by $30,000,000. Augment Item 3790-101-6071 by $30,000,000.)

New Bond Funds for Local and Regional Parks. In November 2006, the voters passed Proposition 1C, which provides funding for various housing and development programs. One of the programs in the measure, Housing Urban-Suburban-and-Rural Parks, provides $200 million to add parks in the vicinity of housing developments. Although Proposition 1C does not specify an implementing department for these funds, the administration is proposing that HCD administer them.

Budget Proposal for Local Parks Funds. The budget proposes two positions and $685,000 for HCD to begin implementing a grant program for housing-related parks. The funding request includes $350,000 to reimburse DPR for work on the program. In addition, the budget requests $30 million in bond funds to be allocated to eligible park projects under the program in 2007-08.

Designate DPR Administrator of Proposition 1C Park Funding. The HCD has only limited experience administering park programs, while DPR has had an established process to implement bond-funded grants and loan programs for park development for many years. Over the last decade, DPR administered approximately $1.7 billion in bond-funded grants for local and regional parks.

As discussed in our piece "Implementation of the Housing Bond" (in the "Crosscutting Issues" section of this chapter), we believe that designating DPR as the primary administrator of all bond funding for parks would result in lower overall state administrative costs, more consistent project evaluation and better coordinated project selection, than if the two agencies (DPR and HCD) administer separate grant programs for park development. Accordingly, we recommend that the Legislature designate DPR as the primary administrator for the parks program funded by Proposition 1C.

Delete Funds for Staff Support for HCD. Consistent with our recommendation that DPR administer the Proposition 1C park funds, we recommend that HCD's request of $685,000 and two positions be deleted. We, however, do not recommend adding staff to DPR to implement the Proposition 1C parks program at this time. This is because DPR has an existing park granting program and it is proposing additional staff to administer Proposition 84 local park funds as well. Specifically, for 2007-08, the budget proposes $1.4 million in Proposition 84 funds and ten positions for DPR to plan and develop grant guidelines, and carry out other administrative tasks related to the grant program. With these staff resources, it is likely that implementing the Proposition 1C funds would require minimal additional staff.

Appropriate Local Assistance Funds to DPR. Consistent with our recommendation that DPR be the primary administrator for all parks programs, we recommend shifting $30 million in Proposition 1C funds requested for projects from HCD to DPR.

Specify Funding Amount for Parks

Proposition 1C allocates $850 million for the Regional Planning, Housing and Infill Incentive program to provide incentive grants that promote infill housing and development. The measure allows up to $200 million of the amount to be used for park development or rehabilitation, but does not allocate a specific amount for these purposes. We recommend the enactment of legislation to specify what portion of the $850 million should be allocated to parks.

Proposition 1C authorizes a total of $850 million for a new Regional Planning, Housing and Infill Incentive program. Funds may be used to provide grants that can go for a number of purposes, including water, sewer, transportation, and other infrastructure development. Proposition 1C also allows up to $200 million to be used for park grants to encourage infill housing and development. However, for that purpose, the measure does not specify a particular amount of funding.

In the section above, we recommend that DPR be designated as the administrative agency to implement the Housing Urban-Suburban-and-Rural Parks program established by Proposition 1C. Consistent with that recommendation, we also recommend that DPR be designated as the agency to administer the portion of park funding out of the $850 million infill incentive program. In this way, all parks-related bond programs would be consolidated under DPR. Accordingly, we recommend the enactment of legislation specifying what portion of the $850 million allocation is to be spent on parks, and would be administered by DPR. Annual funding would then be appropriated through the budget.

EMPLOYMENT DEVELOPMENT DEPARTMENT (7100)

The Employment Development Department (EDD) is responsible for administering the Unemployment Insurance (UI) and Disability Insurance (DI) programs. The department collects from employers (1) their UI contributions, (2) the Employment Training Tax, and (3) employee contributions for DI. It also collects personal income tax withholding. In addition, it pays UI and DI benefits to eligible claimants.

The department also, with the assistance of the state Workforce Investment Board (WIB), administers the federal Workforce Investment Act (WIA) program, which provides employment and training services. Local area WIBs partner with EDD's Job Services program to provide job matching and training services to job seekers and employers.

The budget proposes expenditures totaling $10.8 billion from all funds for support of EDD in 2007-08. This is a decrease of $332 million, or 3 percent, below current-year estimated expenditures. The decrease is primarily the result of lower estimates of UI and DI benefits for the budget year. The budget also proposes $44.4 million from the General Fund in 2007-08, which is an increase of $13.4 million (43 percent) compared to the current year. This increase is primarily the result of realigning some shared costs for EDD's tax collection functions from special and federal funds to the General Fund.

Budget Proposes Reduction in Job Services Program

The Governor's budget proposes to decrease the Job Services program by $27 million. We withhold recommendation on this proposal because the department was unable to provide supporting information at the time this analysis was prepared.

Background. The general purpose of the Job Services program is to link job seekers and employers. In addition to CalJOBS, which is an internet labor exchange system, the program provides a number of specialized services for job seekers who require special assistance, such as individuals with disabilities, veterans, California Work Opportunity and Responsibility to Kids (CalWORKs) recipients, parolees, and youth.

Funding. The Job Services program is funded primarily with federal Job Service Grants (also known as Wagner-Peyser Act funds). In 2006-07, the state used $90 million in federal funds, and $27 million from the EDD's Contingent Fund, to support the Job Services program. The Contingent Fund is comprised of penalties and interest levied against employers for insufficient tax or UI withholding for employees. Any excess Contingent Fund at the close of the fiscal year is transferred to the General Fund.

Governor's Proposal. The Governor's budget proposes to remove $27 million in Contingent Fund from the Job Services program, resulting in an identical General Fund savings. The initial proposal provides no details regarding the impact of this reduction on the provision of employment and training services, though EDD has stated that it plans to issue a budget change proposal with more information. Accordingly, we withhold recommendation at this time, pending the receipt of additional information.

WIA Discretionary Funds

The* 2007-08 Budget Bill *schedules the proposed expenditure of federal Workforce Investment Act (WIA) discretionary funds within broad categories. We provide a comparison of proposed expenditures within the categories to the prior year and recommend the redirection of $3.4 million in WIA funds proposed for new regional collaboratives to instead offset General Fund costs in the existing parolee employment programs. We further recommend the adoption of budget bill language to allocate funds for these specific purposes.

Background. The federal WIA of 1998 replaced the Job Training Partnership Act, which provided employment and training services to unemployed and disadvantaged workers. The goal of WIA is to strengthen coordination among various employment, education, and training programs. Pursuant to federal law, 85 percent of the state's total WIA funds (an estimated $413 million in 2007-08) are allocated to local WIBs. The remaining 15 percent of WIA funds ($62 million in 2007-08) is available for state discretionary purposes such as administration, statewide initiatives, and competitive grants for employment and training programs. The federal law states that all WIA funds "shall be subject to appropriation by the state Legislature."

Proposal for Discretionary Funds. Based on information provided by EDD, Figure 1 shows the Governor's expenditure plan for state discretionary WIA funds. As the figure shows, administration and program services total $27.6 million for 2007-08. These are for ongoing administration of all WIA programs (such as oversight, financial management, and labor market information services). The remaining $34.4 million is proposed for discretionary grants in three program categories scheduled in the budget bill: Growth Industries, Industries with a Statewide Need, and Removing Barriers for Special Needs Populations.

Changes From Current Year. The administration's proposal for the three program categories contains significant changes. The administration's proposal reduces the amount of funds directed specifically to training of Nurses and other Health Care Providers, from $8 million in 2006-07 to $4.9 million in 2007-08. Moreover, this funding would be used to train construction and logistics workers as well as those in nursing and healthcare. The budget proposal adds an additional $1 million in Youth Grants, and decreases the Governor's Veterans' Grants by $2 million. (Though not shown in this display, the Governor's budget also proposes to supplement this category of Veterans' grants with an additional $1 million from WIA Rapid Response funds to assist in reemployment of returning veterans.)

Regional Collaboratives. One new funding initiative proposed for 2007-08 is a total of $4 million for regional collaboratives, a sub-category in each of the three schedules. According to EDD, this program would fund training projects identified by regional collaboratives of business, labor, private foundations, and other public agencies. Similar projects, called Collaborative Regional Initiatives, were developed in the mid-1990s in a number of regions around the state. An evaluation found that although the projects were moderately successful at building networks in the region, they mostly fell short in the key area of meeting their job placement goals. Generally, the evaluation found that the collaboratives showed no significant advantage over other established workforce development entities in providing effective workforce services. Given this weak evaluation, we believe there is insufficient justification for the $4 million proposed for regional collaboratives.

Reduction in Funds for Parolee Programs. The administration also proposes to reduce the funds provided for programs operated by the Department of Corrections and Rehabilitation (CDCR) that serve female offenders and parolees. The budget proposes to use General Fund support to backfill a $3.4 million decrease in WIA funds. In the "Judicial and Criminal Justice" chapter of our analysis, we find that these programs have value in reducing recidivism for parolees. Given that the proposal to add $4 million for regional collaboratives is not justified, we recommend redirecting $3.4 million of the regional collaborative funding to continue the funding of the parolee employment programs in CDCR (Item 5225). This redirection will result in an identical amount of General Fund savings in that item.

Figure 1

Workforce Investment Act (WIA) State Discretionary Funds

(In Millions)

Budget Bill Schedule/Project	Estimated 2006-07	Proposed 2007-08
(1) WIA Administration and Program Services	$28.5	$27.6
(2) Growth Industries		
Biotechnology	$1.0	—
Community colleges WIA coordination	0.6	$0.6
High wage/high skill job training	2.1	2.7
Regional collaboratives	—	1.3
Incentive grants[a]	0.2	0.2
Subtotals	($3.7)	($4.8)
(3) Industries With a Statewide Need		
Nurse Education Initiative	$6.2	$6.2
Nurses/healthcare/construction/logistics[b]	8.0	4.9
Regional collaboratives	—	1.3
Subtotals	($14.2)	($12.4)
(4) Removing Barriers for Special Needs Populations		
Female Offenders' Treatment and Employment Program	$1.7	$1.1
Parolee services	7.9	5.2
Regional collaboratives	—	1.4
Incentive grants[a]	0.5	0.5
Services to long-term unemployed[a]	1.7	1.7
Governor's award for veterans' grants	5.0	3.0
Veterans/disabled veterans' employment services	0.7	0.7
Department of Education WIA coordination	0.5	0.3
Youth grants[a]	1.0	2.0
Low wage earners	1.7	1.3
Subtotals	($20.7)	($17.2)
Total Proposed Expenditures	**$67.1**	**$62.0**

[a] For 2006-07, these grants were listed under Administration and Program Services.

[b] For 2006-07, these grants were for nurse and other healthcare providers only.

Detail may not total due to rounding.

Legislative Changes to Discretionary Funds. Although the amounts for the three WIA programs: Growth Industries, Industries with a Statewide Need, and Removing Barriers for Special Needs Populations tie to the budget bill appropriations, the Governor is not bound to the specific projects within the schedule categories that are displayed in Figure 1. To the extent that the Legislature wishes to adopt the recommendation to redirect funds as described above, or to identify other specific projects or priorities, it will be necessary to adopt budget bill language specifying such allocations from the specific appropriation amounts. Therefore, we recommend that the Legislature adopt budget bill language specifying that of the WIA funds available, $8 million be allocated for parolee services and $1.7 million for the Female Offenders' Treatment and Employment Program in 2007-08.

DEPARTMENT OF FINANCE
(8860)

The Department of Finance (DOF) advises the Governor on the fiscal condition of the state and develops the Governor's budget. The department also provides economic, financial, and demographic information. In addition, the department oversees the operation of the state's accounting and fiscal reporting system and has a unit that assesses the operation of the state's programs.

The Governor's budget proposes to move DOF's Office of Technology Review, Oversight and Security out of DOF. Under the administration's proposal, technology review and oversight would move to the new Office of the Chief Information Officer (see Item 0502 for a discussion of this proposal). The DOF security staff would move to a new Office of Security and Privacy Protection within the State and Consumer Services Agency.

The Governor's budget proposes expenditures of $84.4 million ($68.8 million from the General Fund and $15.6 million in reimbursements) to support the activities of DOF in 2007-08. This is an increase of $33 million, or 64 percent, above estimated current-year expenditures. As discussed below, this increase is due primarily to the continued development of a new computer system.

FINANCIAL INFORMATION SYSTEM FOR CALIFORNIA (FI$CAL)

In 2005 the Department of Finance (DOF) began an information technology (IT) project to replace the state's budget system. After interviewing departments' financial staff, DOF has concluded the project needs to be expanded because most state department automated financial systems are old and do not support modern financial reporting requirements. The Governor's budget proposes a $1.3 billion IT project over the next decade to develop a statewide financial system that would be used by all departments. Our analysis discusses the primary components of this project proposal, key issues the Legislature should consider in

evaluating the project, and recommends additional oversight tools if the Legislature decides the project should go forward.

Background

Original Project Scope. In the fall of 2005, DOF embarked on the planning phase of an information technology (IT) project to replace its internal budget system. The Budget Information System (BIS) project, as it was named, was planned to replace DOF's budget development system. The existing budget system involves the collection of data in multiple systems. The objective of BIS was to implement a single, statewide budget data repository that would meet DOF's budget development needs and the needs of individual state departments. Under the plan, departments would enter their budget requests into BIS and submit them to DOF online. This information would form the basis of the Governor's budget proposal and would allow changes to be tracked throughout the legislative budget process.

Department Interviews Identified Broader Problems. During the first year of the project, BIS staff conducted workshops for budget staff in individual state departments. The purpose of these workshops was to define what the system would do to meet the needs of state departments. The BIS staff consistently heard in these workshops that departments needed more than just a new budget system. Many departments indicated that their automated financial systems were designed decades earlier and did not reflect modern financial reporting requirements. Departments have added subsystems, spreadsheets, and manual processes in order to meet reporting requirements. Problems attributed to these additions were data discrepancies, lack of a clear audit trail, and limited staff who could operate the systems.

Key Components of Proposal

Based on the feedback received from state departments, DOF now proposes to dramatically expand the BIS project. The new proposal is to implement a single, statewide financial system which would encompass budgeting, purchasing, cash management, and accounting. The expanded BIS project has been renamed FI$Cal. We discuss the key components of FI$Cal below.

Project Scope Expanded. The BIS project proposed a seven-year effort to purchase and implement a statewide budget system by 2012. Departments would have been responsible for interfacing their existing financial systems to the new budget system. In contrast, the FI$Cal project plan proposes full implementation by 2015 for over 100 state entities. The project would supply each participating department with a new integrated financial system. The Fi$Cal project cost is estimated to be $1.3 billion over the next decade with as many as 691 staff positions involved in project development, as shown in Figure 1. Figure 2 (see next page) lists the major costs of the project by category. The ongoing costs, once the project is fully implemented, are expected to total $88 million annually. After full implementation, the primary ongoing costs are computer processing at the Department of Technology Services ($45 million), state staff ($16 million), and software licenses ($10 million).

Figure 1

New System Would Cost $1.3 Billion Over the Next Decade

(Dollars in Millions)

Year	Positions	General Fund	Other Funds	Totals
2007-08	236	$37	$1	$38
2008-09	418	221	1	222
2009-10	510	210	1	211
2010-11	632	212	1	213
2011-12	691	105	77	182
2012-13	629	—	136	136
2013-14	507	—	123	123
2014-15	423	—	115	115
2015-16	171	—	88	88[a]
Totals		**$785**	**$543**	**$1,328**

[a] First full year of ongoing maintenance costs.

Uses Commercial Off-the-Shelf Software. The DOF proposes to procure and implement enterprise resource planning (ERP) software. The ERP is an industry term for software that integrates processes to help a business better manage its activities. For instance, in the case of a financial system, the process of approving a purchase order will also create an accounting transaction that encumbers the funds in one step. The software assumes a set of common business processes and provides the framework to automate paperwork. The benefits from an ERP come from the standardization of the business processes and the automation of transactions. Figure 3 (see page 85) summarizes some of the system benefits as presented in the proposal.

Figure 2

Proposed FI$Cal Project Budget

2007-08 Through 2015-16
(In Millions)

Cost Category	Proposed Budget
State employee salaries and benefits	$409.7
Primary vendor contract	352.0
Data center services	287.7
Software	130.5
Additional contracts	56.0
Facilities	29.3
Telecommunications	12.3
Hardware	3.8
Other	46.7
Total	**$1,328.0**

Phased Implementation. Under the project proposal, the new system would be implemented in four phases:

- The first departments converted would be the control agencies whose financial systems are central to the state's financial functions: DOF, Department of General Services, State Controller's Office (SCO), and the State Treasurer's Office. These agencies would have to significantly modify their operations to fit within the ERP framework. At this stage, SCO's 21st Century project—an ERP for the state's payroll and personnel management—would share data with FI$Cal.
- In the second phase, a cross section of departments with financial systems of various sizes and complexity would be converted.
- Most of the remaining departments would be converted in the third phase.
- Finally, several departments which have already replaced their financial systems with ERPs would be integrated into FI$Cal.

Existing Projects Would Go Forward. Two large financial system replacement projects are currently in process at the Department of Transportation (Caltrans) and Department of Corrections and Rehabilitation (CDCR). Both of these projects are in the procurement phase and are currently estimated to cost a combined total of $184 million. The FI$Cal project plan assumes that these projects will go forward because (1) the Caltrans and CDCR financial systems are complex and would not be good candidates for early FI$Cal project implementation and (2) postponing their replacement would create too much risk to these departments' financial operations. Therefore, they would be allowed to proceed and would be integrated in the fourth phase of implementation.

Figure 3

Administration's Proposed FI$Cal System Benefits

Current State Systems	Proposed FI$Cal System
• Multiple systems within departments covering revenues, expenditures, cash balances, and project accounting.	• Single system within and across departments.
• Subsystems (such as spreadsheets and small databases) maintained to gather and summarize data detail.	• Data available at detail and summarized levels.
• Work is largely manual, generating paper documents at multiple stages.	• Work is automated within the system.
• Multiple points of redundant data input.	• Single data input.
• Manual reconciliations required between systems to confirm data.	• Single data entry eliminates need for data reconciliations.
• System information not accessible from outside of the department.	• System information accessible from outside of the department based on authorizations.
• Requires major efforts to obtain statewide information.	• Statewide information available on demand based on authorizations.

Standardize Statewide Financial Processes. The project goal is to adjust departments' business processes and not customize the software for individual departments. Thus, a key assumption underlying the project is that state departments will modify their operations to fit within the ERP framework. In many cases, these changes could be significant.

Bring Staff in Early. The project plans to hire a team of full-time state financial staff who have experience in the state's existing financial processes. In order to backfill departments' losses of experienced staff, the project plans to provide sufficient funding to departments so they can hire replacement staff a year ahead of the project taking experienced staff.

This would allow time for the training and mentoring of the new staff in preparation for the departure of the experienced staff.

Training and User Support. Throughout the course of the system implementation, staff who gain experience in how to use the new system would then help convert subsequent departments to the new system. Ultimately, the project plans for a help desk and a training center using these experienced staff.

Savings Identification. The FI$Cal project proposal does not include a savings estimate from any efficiencies garnered by the system. Instead, a cost avoidance estimate is projected in the range of $3 billion to $5 billion over the next five years. This estimate was developed from information about the condition of existing state financial systems that are assumed will need replacement in the absence of the FI$Cal proposal.

Funding Plan. The project funding plan proposes to use General Fund support for planning and early development activities. During this time, DOF plans to work with the federal government to develop a methodology for allocating project costs to special and federal fund appropriations. Once the methodology is established, the special and federal funds will pay the majority of costs in the later years to reflect their minimal contributions during the early phases of the project. The plan currently reflects special and federal fund sources starting in 2011-12.

Key Considerations

As the Legislature contemplates the major investment of state resources, it will face a number of key questions, which we discuss below.

Scope, Schedule, and Cost

Unified Approach. The FI$Cal project plan treats the state's financial infrastructure as a single system. In the 1980s, CALSTARS was California's first attempt to achieve a single statewide financial system. The vision was to provide a statewide view of the state's expenditures. However, CALSTARS was never meant to be a complete financial management solution as it was not designed to handle revenues or cash management. Implementing an ERP would allow the state to put all its financial processes in a single system. Such a unified approach offers several benefits—like uniform reporting and easier training of financial staff.

Is the Schedule Realistic? The project schedule reflects full implementation for over 100 state entities over the next decade. Even though a large number of staff resources would be provided under the plan, maintaining this schedule would require an aggressive pace. Each department's financial processes would be reviewed and altered by the new system. Given that each department's processes are unique, the project could encounter delays from a single department's circumstances. In addition, recruiting the number of proposed project staff could create a challenge to staying on schedule. Contributing to this challenge are the Caltrans and CDCR financial ERP projects, which are planned to progress ahead of this project and will also need to add staff.

Is the Budget Realistic? The project proposal is realistic about the major financial commitment for this effort. Given the statewide involvement that will be necessary, the resources identified are representative of the investment that would be required to be successful. However, the project budget includes estimated contract costs that are 30 percent of the total budget. It is difficult to know the accuracy of the budget until after the procurement of these contracts.

Capturing Savings. As stated earlier, the project proposal only identifies savings from potential cost avoidances from future individual IT proposals. The administration did not assume any direct departmental savings from the improved efficiencies of an integrated fiscal IT system—such as reduced data entry, increased ease developing the budget, and less staff time spent gathering information. The project plan, however, commits the administration to capturing information related to departmental activities before and after system implementation. The Legislature, therefore, would be able to identify specific cost savings at a later date.

Role of Control Agencies

Rethinking Processes. The ERP software first introduced in the early 1990s was focused on private sector business processes. Over the past several years, public sector software versions have been released which focus on governmental accounting and fiscal practices. Several states have implemented ERPs and several more are in process. These states report that a major benefit of these systems is standardized processes across state organizations. Rethinking California's most basic financial processes to achieve this benefit would be the FI$Cal project's greatest challenge and biggest risk. An ERP system's built-in business processes are based on industry and public-sector standards and need to be adopted in order to take advantage of its integrated features. Although several ERP systems have been implemented in California state departments, none have experienced these benefits. These departments were forced to make customized changes to the software in order to meet existing control agency processes. For instance, control agencies often mandate forms to be submitted in hard copy. An ERP system for a state entity, therefore, must be customized to generate printed copies even though the system is designed to use electronic transmissions. For example, SCO still requires that departments send hard copy bundled invoices (called claim schedules) for payments made by the state to vendors. These kinds of manual processes reduce the benefit of a modern online processing system (ERP). In addition, the longevity of the system's usefulness is proportional to the extent that the software is implemented without customization. Upgrading the ERP software becomes much more difficult and expensive to the extent customization has occurred.

Defining Roles and Responsibilities. Under the project plan, a formal memorandum of understanding (MOU) between DOF and each of the other control agencies would be signed to provide a framework for their partnership. The MOU would lay out the roles and responsibilities for each department. Under the plan, each control agency would have "ownership" of their respective business areas in relationship to the system. Each partner, therefore, would have the authority to ultimately determine how the system will be developed and configured in relation to their business activities. While this will ensure each agency has a vested interest in the project, it also increases the potential for customization and creates added risk. It will be crucial, therefore, that executives in each control agency understand the importance of redesigning their work processes to fit the software.

Transitional Challenges. In addition, control agencies will have to manage many organizational challenges that may result from the redesigning of their processes. Particularly during the transition period to the new system, these challenges may include:

- Parts of the organization experiencing temporary disruptions.
- Functions shifting between units within the organization and changing reporting relationships.
- Staff having to acquire new skills and knowledge, which could affect classifications and salaries.
- Staff resisting the changes to long-time processes.

Project Leadership. Over the course of a decade-long project, there will inevitably be leadership changes within both the project and the control agencies. Throughout this time, project and control agency leaders would need to maintain their commitment to major change. It also would be important for FI$Cal leadership to be experienced in state administrative processes and place an emphasis on maintaining close communications among executives in the partner departments.

Weighing Potential Benefits and Tremendous Costs

The Legislature will need to weigh the potential benefits of a statewide system against its tremendous costs. Current financial systems across state departments are antiquated. Many current systems use old technologies for which maintenance will become increasingly difficult over the next few years as knowledgeable state staff retire. In addition, these older systems are inefficient and labor intensive to use. Many departments struggle to close their accounting books within regulatory time frames each year.

To the administration's credit, it has developed a project plan that relies on various industry "best practices" for implementing large IT projects. For instance, the project has garnered executive support and has a defined governance structure. In addition, the project plan emphasizes departmental involvement, training, and ongoing support for the system's users. Even so, a project of this complexity and statewide impact would be full of risks.

Key Issues. As discussed above, there are a number of issues that should be given careful consideration as the Legislature decides if this project should proceed. As the Legislature reviews the proposal during the spring budget process, we recommend the administration address key questions, including:

- Do the control agency executives understand their agencies' responsibilities in the FI$Cal project? Do they understand the potential organizational impacts? Are they committed to leading their organizations through major upheaval and modernizing decades-old processes?
- What are the benefits of moving forward with the Caltrans and CDCR ERP systems while FI$Cal is under development? Are the extra costs and risks worth having these ERP systems in place for just a few years prior to FI$Cal? Could the administration instead just prioritize these departments to the early stages of FI$Cal implementation?
- Why are special funds not sharing in the early costs of the project? What assurances will the state have that the federal government will pay a share of the costs?

Project Would Need Special Oversight Tools. If the Legislature chooses to pursue the FI$Cal project, we recommend increased legislative oversight that is reflective of the project risk. In its oversight, the Legislature's emphasis should be to ensure (1) that there is a clear understanding of roles and responsibilities and (2) that the appropriate controls are in place to maximize the potential for project success. The additional oversight might include:

- An increase in the standard 30-day legislative review time prior to contract signature. Additional review time, perhaps with hearings, would allow the Legislature time to review and understand the contract's conditions.

- The use of independent reviews of key aspects of the procurement and the project implementation. For instance, the Legislature required the Bureau of State Audits to audit and report on the procurement phase of the California Child Support Automation System project.

- A requirement that DOF develop a succession plan for the project's executive team to ensure competent leadership throughout the length of the project.

In the coming years, the state will be forced to take action to address its aging financial infrastructure. The administration has proposed a comprehensive, but costly, solution. Its implementation would require diligent management by the control agencies and targeted oversight by the Legislature.

COMMISSION ON STATE MANDATES
(8885)

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

Under Proposition 1A, approved by the state's voters in 2004, the Legislature must appropriate funds in the annual budget to pay a mandate's outstanding claims, "suspend" the mandate (render it inoperative for one year), or "repeal" the mandate (permanently eliminate it or make it optional). Two categories of mandates—those relating to K-14 education and employee rights—are exempt from this payment requirement. Proposition 1A also authorizes the state to pay over a period of years outstanding noneducation mandate claims incurred prior to 2004-05. The state's backlog of these claims totals $914 million.

NO FUNDS TO PAY 2007-08 MANDATE BILLS

In recent years, the state has appropriated funds under the commission's budget item to pay all of the state's mandate bills, except bills relating to K-12 districts, community colleges, and one county mental health mandate referred to as the "AB 3632 mandate." Last year, the budget provided $404 million under this item for these purposes, including $169.9 million to pay two years of a 15-year plan to pay the backlog of accumulated pre-2004-05 mandate bills. (Funding for education and the AB 3632 mandates is appropriated under K-12, community colleges, and the Department of Mental Health [DMH] budgets.)

Inconsistency Between Budget Funding and Government Code

We recommend the administration either propose funding to pay local governments' mandate bills in 2007-08 (about $150 million) or propose legislation to modify the Government Code to reflect its delayed payment schedule.

The 2007-08 budget includes no funding to pay noneducation, non-AB 3632 mandate claims. The administration explains that the state can realize a one-time savings in 2007-08 because: (1) funding in the 2006-07 budget provides sufficient resources to pay all mandate bills submitted in the current year and to make the 2007-08 backlog payment and (2) Proposition 1A shifted the mandate payment due date and now permits the state to pay mandate bills one year *after* the fiscal year in which local governments submit mandate bills.

Our review indicates that the administration's first assertion may be accurate. While the State Controller's Office (SCO) is still paying and auditing mandate bills, there appears to be sufficient resources in the 2006-07 budget to pay these mandate bills and make the 2007-08 backlog payment. The SCO advises us that it will have updated estimates of mandate costs in the spring and will provide this information to the Legislature at that time.

With regard to the administration's second assertion (that Proposition 1A shifted the payment date for mandates), we find that the administration's proposed payment schedule is inconsistent with the longstanding payment schedule in the Government Code. Specifically, the Government Code (which was not modified by Proposition 1A) permits local governments to file for mandate reimbursements in the year in which the local government carries out the mandated activity. It further directs SCO to pay these claims promptly, imposing interest penalties on the state if SCO does not pay the claim within 60 days. Thus, while Proposition 1A *permits* the state to pay mandate bills one year after the local government submits the bills, the Government Code specifies an earlier payment schedule.

In our view, paying mandate bills in the year in which the state imposes a mandated responsibility makes good policy sense. Otherwise, the state may be less likely to consider the fiscal consequences of its actions when making decisions whether to maintain, repeal, or suspend a mandate. For 2007-08, we estimate the cost of funding all currently active (that is, not suspended) mandates would be about $150 million. (This estimate excludes education mandates and AB 3632.)

Accordingly, we recommend the administration propose funding for the mandates it proposes be active in 2007-08. Alternatively, if the administration wishes to postpone these mandate payment obligations, using the flexibility provided under Proposition 1A, we recommend the administration propose changes to the Government Code to be consistent with its delayed payment schedule.

No Proposal Regarding Three New Mandates

We recommend that, prior to budget hearings, the Department of Finance clarify its budget proposal regarding three of the four mandates recently identified by the commission.

Chapter 1123, Statutes of 2002 (AB 3000, Committee on Budget), requires the Legislative Analyst's Office to review each mandate included in the commission's annual report of newly identified mandates. In compliance with this requirement, we reviewed the four mandates shown in Figure 1. We discuss the Integrated Waste Management mandate under our analysis of the California Community Colleges. We raise no policy issues with the three criminal justice mandates.

Three of the four mandates shown in Figure 1 (each of the mandates after False Reports of Police Misconduct) were reported to the Legislature after September 2006. Perhaps due to this late date, the budget bill does not specify the administration's proposals regarding them. That is, the budget bill does not identify funding for them, suspend their requirements, or indicate that their costs are to be deferred. We recommend that, prior to budget hearings, the Department of Finance (DOF) notify the budget subcommittees whether it proposes to fund, defer, repeal, or take other actions concerning these three mandates.

Figure 1

Newly Identified State Mandates

Mandate	Administration's Budget Proposal	Statewide Cost Estimate
False Reports of Police Misconduct	Fund	$126,024
Crime Victim's Domestic Violence Incident Reports	None specified	918,998
Peace Officer Personnel Records: Unfounded Complaints and Discovery	None specified	1,833,051
Integrated Waste Management (community colleges)	None specified	10,785,532
Total		**$13,663,605**

MANDATE PROCESS REFORM

The problems state and local governments are facing with regard to the mandate determination process could be improved substantially by legislative action to (1) facilitate adoption of simpler mandate reimbursement methodologies and (2) authorize alternative processes to determine mandates.

The Governor's budget proposes significant changes to the process the state uses to (1) determine whether a reimbursable mandate exists and (2) specify the methodology by which the mandate would be reimbursed. In our view, the administration's proposal to reform this mandate process provides a good starting point for discussion.

In "Part V" of our accompanying *Perspective and Issues*, we review the administration's proposal and offer the Legislature a similar, but more extensive, proposal that includes three significant changes to the mandate process:

- Simplify the process for local governments to file reimbursement claims by placing greater emphasis on unit cost methodologies.
- Allow mandate payment methodologies to be developed through negotiations between local governments and DOF.
- Establish an alternate process to provide early settlement of mandate disputes and bypass the commission entirely.

STATUS OF MAJOR MANDATES

Over the last several years, the Legislature has reviewed a number of major noneducation mandates and has taken actions to modify the mandates or reduce their costs. We summarize below the status of these mandates.

Peace Officer Procedural Bill of Rights (POBOR). The POBOR (Chapter 465, Statutes of 1976 [AB 301, Keysor]), provides enhanced rights and procedural protections to peace officers who are subject to interrogation or discipline by their employer. At the request of the Legislature in 2004, the commission reconsidered its statement of decision regarding the mandate, but made few changes to the list of activities found to be state reimbursable. In 2005 and 2006, SCO began releasing POBOR audits, disallowing large parts of local governments' claimed costs because they were not consistent with the mandate's claiming methodology or lacked sufficient documentation. In 2006, the commission began working to develop a simpler, easier-to-use POBOR claiming methodology. As of early 2007, no new methodology had been adopted due to significant differences in state and local perspectives regarding the mandate's costs.

Open Meetings Act and the Mandate Reimbursement Process Mandate. Prior to 2005, the state reimbursed local governments over $40 million annually to post agendas in compliance with the Open Meetings Act and to file and prepare mandate reimbursement claims. Chapter 72, Statutes of 2005 (AB 138, Committee on Budget), amended the Government Code to direct the commission not to find a mandate in cases when a state law (1) implements or (2) is "reasonably within the scope of" a voter-approved measure. It further directed the commission to set aside its Open Meetings Act decision and reconsider its Mandate Reimbursement Process decision.

The commission relied on the new provisions of Chapter 72 in overturning the Mandate Reimbursement Process decision (as well as a decision regarding School Accountability Report Cards) and in setting aside the Open Meetings Act mandate decision. In January 2007, the Sacramento Superior Court heard a case challenging the constitutionality of Chapter 72, but no decision has been released to date.

Animal Adoption. At the request of the Legislature, the commission clarified the reimbursement methodology for the animal adoption mandate created by Chapter 752, Statutes of 1998 (SB 1785, Hayden). Under this mandate, stray dogs and cats must be held for an additional three days before being euthanized. The commission's new reimbursement methodology applies to mandated activities taken after 2004 05. Thus far, we have not identified any significant change in the mandate's costs due to the revised claiming methodology. We estimate this mandate costs over $20 million annually.

AB 3632. The current-year budget and proposed budget bill each provide $121 million in annual categorical funding to reimburse counties for their costs to provide mandated mental health services to special education pupils. Specifically, the current and proposed budgets provide $52 million (General Fund) under DMH and $69 million (federal special education funding) under the California Department of Education. County data indicate, however, that the cost of providing services under the AB 3632 mandate will exceed the amounts budgeted. Under existing law, counties may file mandate claims to recoup any program costs not offset through the categorical programs. We estimate that counties will request $40 million as mandate reimbursements for AB 3632 services in the current year and about $90 million in the budget year.

MILITARY DEPARTMENT
(8940)

The Military Department is responsible for the command and management of the California Army and Air National Guard. To support the operations for a force of more than 20,000 personnel, the department maintains a headquarters complex in Sacramento, 111 armories, 37 maintenance facilities, 2 training sites, and 11 aviation centers throughout the state. Additionally, four new armories are currently under construction.

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

The budget proposes expenditure of $131 million, an increase of nearly 3 percent. Nearly two-thirds ($86 million) of the overall funding for the department comes from federal funds and reimbursements, with the remaining one-third ($45 million) coming from the General Fund.

Tuition Assistance Program Duplicates Purpose of Existing Program

We recommend deleting a request for $1.7 million from the General Fund to establish a Tuition Assistance Program as an aid to recruitment efforts. This request duplicates a loan forgiveness program established in 2003. (Reduce Item 8940-001-0001 by $1,699,000.)

Tuition Assistance to Aid Recruiting. The department requests $1.7 million from the General Fund in the budget year to establish a Tuition Assistance Program (TAP) to aid in recruitment efforts. Program costs would grow to $3.3 million annually in subsequent years. The department request is based on the idea that a tuition program of some type is essential to the recruitment activities of the California National Guard and, without such a program, recruiting quotas will go unfilled. The department reports that it needs to recruit 489 members to attain 100 percent of the federally authorized troop strength. Of a total federally authorized troop strength level of 20,698 members, 489 represents a 2.4 percent shortfall.

Program Already Exists for the Same Purpose. This same rationale for improved recruitment led to the National Guard Assumption Program for Loans for Education (NG-APLE), created by Chapter 345, Statutes of 2003 (AB 547, Liu). The NG-APLE is administered by the California Student Aid Commission (CSAC), and pays off student loans for qualified students who fulfill specified terms of enlistment in the National Guard. The CSAC may only award the number of NG-APLE warrants authorized in the annual budget act. No warrants were authorized until the *2006-07 Budget Act*, which authorized 100 grants. The program is due to sunset at the end of 2006-07.

NG-APLE Superior to TAP. There have been concerns about the NG-APLE. For instance, it has taken too long to get off the ground. The CSAC is only now in the process of promulgating regulations for NG-APLE, which are expected to be adopted in April 2007. In addition, there may be too few authorized grants to be of value in overall recruiting. Despite these issues, we believe NG-APLE is superior in design to TAP. First, NG-APLE is easier to administer. As a loan forgiveness program, it only pays benefits once the student has completed his or her military commitment. In contrast, TAP provides payment up front, and thus it would be necessary for the state to try to collect those funds from the student if he or she fails to complete the military commitment. Second, NG-APLE is structured similar to other programs already administered by CSAC. The TAP would create a new program to be administered by the Military Department, which has less experience in administering student financial aid programs. Finally, NG-APLE is established in statute, while TAP would give discretion to the Military Department regarding the allocation of awards.

No Need to Establish New Program. For these reasons, we recommend the Legislature reject the TAP proposal. If the Legislature wishes to continue to provide student financial aid as a way to help recruit and retain National Guard members, we would advise renewing the NG-APLE beyond its June 2007 sunset and authorize additional warrants in the budget year to aid in recruitment.

Department of Veterans Affairs and Veterans' Homes of California (8950-8967)

The Department of Veterans Affairs (DVA) provides services to California veterans and their dependents, as well as eligible members of the California National Guard. The DVA provides home and farm loans to qualifying veterans using the proceeds from the sale of general obligation and mortgage revenue bonds. The department also helps eligible veterans and their dependents obtain federal and state benefits by providing (1) claims representation, (2) subventions to county veterans service offices, and (3) educational assistance. The DVA operates veterans' homes in Yountville, Barstow, and Chula Vista, which provide medical care, rehabilitation services, and residential services. Additional homes at West Los Angeles, Ventura, and Lancaster will begin construction in 2007.

The budget proposes total expenditures of $349 million in 2007-08. This is $26 million (8 percent) more than estimated current-year expenditures. General Fund expenditures of $112 million are proposed, which is $24 million (27 percent) more than the estimated current-year level. This includes $17 million for updated and improved information technology (IT) infrastructure and patient management software and $3 million for equipment replacement at the veterans' homes.

Equipment Request Includes the Kitchen Sink

The Governor's budget proposes new General Fund spending of $3.2 million for ongoing maintenance and equipment replacement throughout the department. The department's proposal does not specify what equipment is scheduled for replacement. We withhold recommendation pending receipt and review of a comprehensive plan.

Proposal to Expand Equipment Purchases. The budget provides $3.2 million from the General Fund in ongoing funding for the three homes and headquarters for equipment purchases and replacement. The department requests this funding to replace equipment that is beyond its functional life or is no longer economical to repair. The request also provides funding for new equipment to meet functional, regulatory, clinical, and safety needs. The department reports that unallocated reductions in past years have forced the elimination of all funding related to equipment.

Plan for Spending Still Being Drafted. While the proposal includes an extensive list of equipment (including three kitchen sinks), it provides little information as to what equipment is to be replaced and how that relates to the dollar level of this request. The department is in the process of developing a maintenance and equipment replacement plan, but fails to tie this request to that plan. While the department has indicated that the plan will be finalized in March, it provided us a draft plan. Even with this draft plan, the request is missing the following key components.

- ***Specific Equipment Lists for 2007-08 Replacements.*** The proposal fails to identify which equipment is most critical and will be purchased in the budget year.
- ***Consistency of Equipment Inventory.*** Overall, the equipment lists provided are extensive for some program areas and contain minimal information in others, reflecting the department's inconsistent approach across the homes and headquarters.

Withhold Recommendation Pending Final Plan. We withhold recommendation until the department submits a comprehensive plan for maintenance and replacement of equipment and the Legislature has had time to review it. The plan should address the concerns discussed above.

Reduce Overly Aggressive Hiring Schedule

The Governor's budget proposes $1 million in General Fund expenditures to hire staff for new homes in Southern California. We recommend the Legislature reduce the request by $374,000. The department's proposal to hire staff for these homes is too aggressive given construction schedules that place opening of the first two homes more than 18 months away from the start of the budget year. (Reduce Item 8967-001-0001 by $374,000.)

Background. The department is engaged in the development of new homes in West Los Angeles, Ventura, and Lancaster that will add approximately 616 beds to the veterans' home system. Current bidding and construction schedules show that the bids for all three homes are to be received in February 2007 with construction to start in July. Construction will last 18 months for both Lancaster and Ventura and 30 months for West Los Angeles.

Request to Begin Staffing. The department's budget requests General Fund support for ten new positions for the West Los Angeles, Ventura, and Lancaster veterans' homes. Six positions are scheduled to start July 1, 2007, and four positions are scheduled to start January 1, 2008. Included in this request are staff to handle accounting, clerical, hospital administration, plant operations, and nursing program development duties. The request indicates that these staff will be located in both Los Angeles (eight staff) and in the Sacramento headquarters office (two staff). Tasks to be accomplished during 2007-08 include clinical program development, IT and capital outlay support, contract management, recruitment, and hiring. The request indicates the department's intent to increase staffing levels to 21 full-time positions in 2008-09.

Request Is Overly Aggressive. Based on the bidding and construction schedules discussed above, the department would be hiring many staff 18 and 30 months in advance of the homes being completed. It makes sense to hire some staff prior to the opening of the homes in order to accomplish many of these tasks. In most cases, however, the tasks described in the proposal should reasonably be handled within a single calendar year before the homes open. The one exception is the Chief of Plant Operations, who will have duties specifically related to the homes' construction.

Request Also Overstates Equipment Needs. Additionally, the department's requests for associated equipment and operating expenses is overly generous. For instance, the purchase of three vehicles is unnecessary. Moreover, the costs of some equipment such as Blackberry devices appears dramatically overstated ($8,000 each).

Recommend Reduction of Department's Request. We recommend reduction of this request by $374,000. This includes a reduction of $228,000 in personal services relating to the timing of positions and $146,000 in operating expenses and equipment. The reduced amount will be sufficient to allow the department to hire the Chief of Plant Operations immediately in July with the remaining nine positions being hired a full 12 months (January 2008) in advance of construction completion of the first new homes.

Baseline Adjustment Faulty

The Governor's budget proposes a $1.5 million General Fund augmentation to cover anticipated increased operating costs at the veterans' homes. We recommend the Legislature reduce this request by $702,000 due to faulty calculations used to project costs. (Reduce Item 8960-001-0001 by $334,000; Item 8965-001-0001 by $32,000; Item 8966-001-0001 by $336,000.)

Nature of the Request. The department's proposal requests $1.5 million from the General Fund for a baseline adjustment to its expense and equipment line items. This amount is intended to cover projected increased costs for pharmaceuticals, contracted medical services, medical supplies, and energy purchases. The department provided information regarding costs over the last five years for these items at each of the veterans' homes, as well as the baseline amount included in the 2006-07 budget. The department's budget-year request applies a five-year average growth rate to the amounts received in 2006-07.

Technical Mistakes in Calculations. The method in which the department calculated the baseline adjustment contains a number of flaws which cause the request to be overstated. For instance, in the case of pharmaceuticals for Yountville, the department determined an average yearly cost of $2.3 million. This is a 30 percent increase over the 2001-02 amount of $1.8 million, for an annual average increase of 6 percent. However, the department arrived at a 26 percent annual increase that it used to adjust the baseline budget. In addition, in the case of Barstow, the population has fluctuated dramatically over the past five years (due to licensing problems). The department failed to accurately account for these swings in applying the cost increases.

Recommend Reduction of the Request. Medical costs have gone up faster at the homes than standard inflationary adjustments—making a baseline adjustment warranted. To arrive at a more appropriate amount, we recommend an adjustment of the 2006-07 baseline funding using projections of medical, pharmaceutical, and energy costs for the budget year. We recalculated the budget request using these estimates (which tend to average between 7 percent and 9 percent) and determined that the department's request is overstated by $702,000. Accordingly, we recommend then that the Legislature reduce the request by that amount.

HEALTH AND DENTAL BENEFITS FOR ANNUITANTS (9650)

Through this budget item, the state contributes toward health and dental insurance premiums of more than 210,000 retired state government and California State University employees, their family members, and other eligible annuitants. The California Public Employees' Retirement System (CalPERS) administers the state's health benefit programs for its employees and retirees. Retirees and other annuitants may choose to enroll in one of several plans from health maintenance and preferred provider organizations. Retirees receive a state contribution—the amount of which is set pursuant to a statutory formula—of up to 100 percent of monthly premium costs for a CalPERS plan. The CalPERS plans often require participants to pay for various costs—such as deductibles, office visit charges, and prescription drug copayments—"out of pocket."

The administration proposes expenditures of $1.06 billion for retiree health and dental benefits in this budget item—with 96 percent of the funds to be appropriated from the General Fund. Although the costs initially are paid from the General Fund, the state recovers a portion of these costs (by about one-third) from special funds through pro rata charges. (The rest of the expenditures in this item would be paid from the Public Employees Contingency Reserve Fund [CRF], as described below.) In addition, the Governor's budget plan sets aside $80 million from the General Fund in an "off-budget" line item to address possible additional costs related to CalPERS' health premium increases for calendar year 2008. (In other words, the use of this additional $80 million to cover rising premiums would not reduce the reserve included in the Governor's budget plan.) Combined, these amounts would result in total state spending of $1.14 billion for state retiree health and dental benefits—an increase of 12 percent from estimated 2006-07 spending levels.

Administration's Estimates Appear Too Optimistic

We withhold recommendation on the request for $1.14 billion for retiree health and dental costs pending the California Public Employees' Retirement System's (CalPERS') determination of calendar-year 2008 health premiums in May or June. Given the recent track record of the CalPERS Board of Administration concerning premium increases, we doubt that costs will remain within the budget assumptions. Under the statutory formula that sets the amount of these benefits, the Legislature probably will have to appropriate additional funds for this item.

Administration's Budgeting Practices Differ From Those of Prior Years. In contrast to the practices of some prior years, the budget and documents released by the administration contain little information about the reasoning and assumptions supporting the amounts included in this budget item. (Such assumptions include the net growth in the state's retiree population and CalPERS' annual rates of health premium increases.)

Budget Assumptions Appear to Be Somewhat Optimistic. Despite the lack of information from the administration, it is obvious that, in order for the Governor's budget plan in this area to be achievable, CalPERS would have to negotiate lower rate increases and/or see a smaller increase in the net number of enrolled retirees and dependents receiving benefits than has typically been the case in recent years. Figure 1 (see next page) shows the recent trend of steep spending increases for this item. While all funds in the budget plan would cover a 12 percent growth in retiree health and dental costs in 2007-08, the average annual rate of spending growth for this item actually has been 16 percent during the last seven years and 14 percent during the last three years. This spending growth results primarily from CalPERS' premium increases, but also from growth in the population of retirees and dependents receiving benefits. If spending requirements for retiree health and dental benefits end up increasing 14 percent in 2007-08, for instance, instead of the 12 percent assumed in the Governor's budget plan, the Legislature would need to appropriate about $25 million more than the amounts proposed by the administration.

CalPERS Board Rejected Plan to Slow Premium Increases Last Year. Under current law and practice, the Legislature delegates to the CalPERS Board of Administration broad powers to (1) design health plans for employees and retirees, (2) set premium rates, and (3) set other charges paid by plan members. In June 2006, the CalPERS' staff recommended that the board approve several benefit design changes—for example, increases of office visit copayments from $10 to $15 and emergency room copayments from $50 to $75 for some plans—that would have reduced the 2007 premium rate increase paid by the state and plan members by as much as

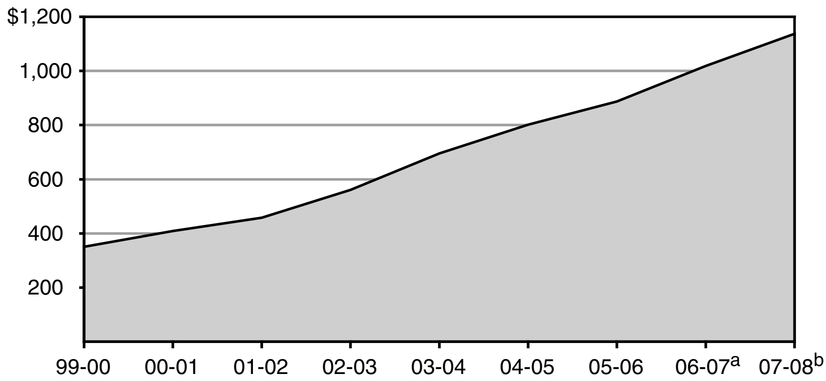
2 percent for some health plans. The staff provided the board with information from published studies that indicated the changes would:

- Encourage more plan members to make fewer expensive emergency room visits with few adverse health effects.
- Focus cost increases on members demanding the most services from the system, while passing on premium decreases to most members, who use fewer services.

Figure 1

Retiree Health and Dental Costs Continue Rapid Climb Upward

(In Millions)



[a] Estimated.
[b] Proposed spending from all funds, including off-budget item.

The board did not adopt these changes. The resulting 12 percent average premium increases for 2008—along with a 5 percent increase in the net number of state retirees enrolled in the program—caused the estimated 15 percent total spending increase in this item during 2006-07. The board's recent track record in containing annual premium increases results in our pessimism concerning the budget proposal for retiree health costs. Should the CalPERS board reconsider its decision and adopt a similar plan design proposal to take effect in 2008, the state's cost increases for retiree health benefits may be less in 2007-08 than in some recent years. In such an event, it is more likely that the amounts proposed by the Governor would be sufficient to pay for the state's benefit commitments.

Valuation of Retiree Health Unfunded Liabilities Should Be Released This Year

As we discussed in* The 2006-07 Budget: Perspectives and Issues, *new governmental accounting rules soon will require the state and other public entities to identify unfunded liabilities for retiree health and dental benefits. We expect the state's first valuation of these liabilities to be released during 2007. A new 12-member commission to be appointed by legislative leaders and the Governor is expected to consider issues concerning public employee retiree health and pension systems during 2007. We continue to recommend that the Legislature (1) begin to set aside money to address state retiree health liabilities and (2) require improved disclosure of these liabilities by local governments, including school districts.

State and Other Public Employers Have Large Retiree Health Liabilities. As we discussed in the 2006-07 *P&I* (see pages 119 through 144), the vast majority of public entities nationwide that offer health benefits to retired employees—including the State of California—pay for such benefits on a "pay-as-you-go" basis. This means that the governments pay for the benefits used by retirees and their eligible dependents each year. In contrast, most governments—including the state—have prefunded pension benefits for decades. When governments prefund retirement benefits (rather than funding them on a pay-as-you-go basis), they avoid forcing future taxpayers to pay for the compensation provided to public employees for services rendered in prior decades. Prefunding retirement benefits also reduces governmental costs over the long term. Since funds can be invested, the resulting investment returns (instead of current tax revenues) can cover large portions of benefit expenses. In the public sector, prefunding defined pension benefits and limiting the amounts of unfunded pension liabilities are well-established public policies at the state and local level. Because most governments do not prefund retiree health benefit costs at all, the unfunded liabilities to be reported under new governmental accounting rules often will be massive. Nationwide, state and local unfunded retiree health liabilities now are forecast to exceed $1 trillion. The State of New York and New York City have reported unfunded retiree health liabilities of about $50 billion each. The State of California's retiree health program is similar in size to those of each of these New York governments.

Awaiting Release of the State's Liability Valuation. In the *2006-07 Budget Act*, the Legislature appropriated $252,000 to the State Controller's Office (SCO) to contract with actuaries to produce the state's first retiree health liability valuation, consistent with the new accounting rules. The valuation is expected to be released in calendar year 2007. Based on the results of other valuations being released by public entities nationwide, we continue to believe that (1) the state's unfunded retiree health liabilities total between $40 billion and $70 billion and (2) the annual amount that the state would have to appropriate to eliminate this unfunded liability over 30 years could be somewhere around six times the current level of spending for retiree health and dental benefit costs ($6 billion). The actual amounts to be released by the SCO's actuaries could be less or more than these amounts, depending on the assumptions they use for health care premium inflation in the future, investment returns that would be generated by funds the state might invest for this purpose, demographics of state employees and retirees, and other factors. At the local level in California, some governments already have released their retiree health valuations. We expect that hundreds of additional local governments will release their first valuations during 2007.

Governor's Public Employee Post-Employment Benefits Commission. In December 2006, the Governor established this commission and directed it to report to him and the Legislature by January 1, 2008, on the following topics:

- The estimated amounts of unfunded retiree health and dental liabilities for state and local governments in California.
- An evaluation and comparison of various approaches to address governments' unfunded retiree health and pension obligations.
- The advantages to governments from offering health benefits to retired public employees.
- A proposal to address governments' unfunded retiree health and pension obligations.

The commission will include three appointees of the Speaker of the Assembly, three appointees of the President pro Tempore of the Senate, and six appointees of the Governor.

LAO's Recommendations on Retiree Health Care. In the 2006-07 *P&I*, we discussed some of the matters that the commission is expected to study, including methods that the state and local governments could adopt to address unfunded retiree health liabilities. In general, these methods fall into two categories: (1) identifying new funding and investing it to prefund retiree health benefits—an approach that we recommended that the Legislature begin to implement—and (2) changing benefits so as to reduce increases in future costs. In the 2006-07 *P&I*, we also recommended several measures to improve the disclosure of retiree health liabilities by local governments, including school districts, so that elected leaders and citizens will have information to make informed choices concerning state and local policy.

Approve Plan to Use Medicare Employer Funds For Retiree Health Costs

We recommend that the Legislature approve the administration's proposal to use an estimated $38 million of Medicare Part D employer subsidy funds received in 2006-07 to pay a small portion of 2007-08 state costs for retiree health benefits. If the proposal is not approved, then General Fund costs would increase by $38 million. We further recommend technical changes to the proposed budget bill language to conform with this action.

Congress Provided Subsidy Funds to Reduce Employer Costs. The federal Medicare drug plan—known as Medicare Part D—went into effect beginning January 1, 2006. As of that date, Medicare began to pay for outpatient prescription drugs for certain individuals. Since some employers—like the state—already provide prescription drug benefits comparable in scope to those provided under the Part D program to their eligible retirees, Congress created a subsidy program, the Retiree Drug Subsidy (RDS) program, to encourage employers to continue offering drug coverage to retirees. The RDS subsidy equals 28 percent of allowable drug costs between $250 and $5,000 per calendar year for each Medicare-eligible health plan member and their dependents. In the 2006-07 budget, the Legislature directed CalPERS to apply for RDS subsidies and provided a small appropriation for additional staff positions necessary to handle the subsidy applications. The CalPERS estimated that 2006-07 RDS receipts would total about $38 million for the state. The Legislature directed that state RDS receipts be deposited to a special account and not spent (except to support the staff costs mentioned above), pending a later decision on how to spend the funds.

Attorney General Opinion Says Subsidies Should Be Deposited to CRF. Following the legislative action described above, the CalPERS Board of Administration requested the state Attorney General to opine on the legality of the decision to hold the funds in a special account for future legislative determination. The Attorney General opined that RDS funds must be deposited in the CRF, a state fund that is continuously appropriated for the purpose of funding CalPERS health benefit plans. The law provides that funds in CRF may be utilized "to reduce the contributions of employees and annuitants and employers" in CalPERS' health plans. We understand that RDS subsidy receipts have begun to be deposited to an account in CRF, consistent with the Attorney General's opinion.

Legislative Direction Is Crucial to Ensure Funds Are Used as Intended. The Governor's budget includes language directing that the $38 million of RDS funds received in 2006-07 and now being deposited into CRF be used to offset costs that otherwise would be paid from the

General Fund for retiree health costs. While the CalPERS board has asked that the funds be deposited to the CRF, some members of the board also have demanded that the funds be spent as they deem appropriate. These members have suggested that the funds should be used largely or entirely to reduce retirees' out-of-pocket prescription drug costs. As discussed earlier, reduction of out-of-pocket costs tends to increase utilization of services and employer premiums. This would increase the state's General Fund costs for retiree health benefits, rather than decrease the costs, as the administration proposes. Because the CalPERS board may wish to divert CRF moneys to this purpose and increase General Fund expenditures, legislative direction concerning the usage of the funds is crucial.

Recommend That Funds Be Used to Reduce Employer Costs, as Intended. Congress established the subsidy program to offset cost increases of employers that offer drug coverage to retirees, so as to encourage them to keep offering the coverage. The RDS funds were intended to be used as the administration proposes—to reduce employer costs and to help employers continue to afford to provide these benefits. In fact, an April 2006 letter to governmental accounting board officials from the National Conference of Public Employee Retirement Systems, the national organization for teachers' retirement systems, and several of the nation's largest public employee unions made this case forcefully. The letter stated, "The subsidy is built into the program to retain these benefits and to lower costs to taxpayers. By its action in drafting the original legislation, Congress declared its intent that these subsidy payments should reduce employer obligations." The funds were *not* intended to be used as some on the CalPERS board propose—to reduce retirees' out-of-pocket costs. The administration's proposal, by contrast, would fulfill congressional intent in this regard, and therefore, we recommend that the Legislature approve it. We further recommend that the Legislature adopt technical changes to the proposed budget bill language to conform with this action.

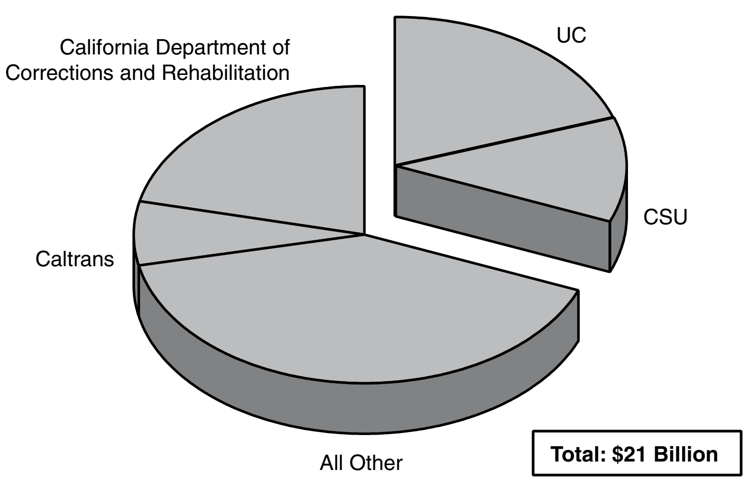
EMPLOYEE COMPENSATION
(9800)

Compensation for state employees drives a significant portion of state government's operating costs. The *2007-08 Governor's Budget* projects over $21 billion in salary and wage expenditures for 345,000 authorized personnel-years (PYs) in 2007-08 (including $6.7 billion and more than 120,000 PYs in higher education). Figure 1 displays a breakdown of these projected 2007-08 payroll expenses (excluding expenditures for benefits—such as health insurance and retirement). As shown in the figure, higher education—consisting of the University of California (UC) and California State

Figure 1

Budgeted State Payroll

2007-08



University (CSU) systems—represents nearly one-third of state payroll costs. The California Department of Corrections and Rehabilitation (CDCR) and the Department of Transportation combined represent over one-quarter of state payroll.

The state also pays for benefits such as health insurance and retirement, which equal over 30 percent of salary expenditures. Thus, when benefits are included, total estimated expenditures for employee compensation are projected to exceed $28 billion for the budget year. The General Fund supports more than one-half of this total.

State civil service employees—which exclude UC, CSU, judicial, legislative, and various other employees—generally belong to one of 21 bargaining units. Figure 2 shows the recent history of general salary increases (GSIs) for state civil service employees and the consumer price indices for the United States and California. Rank-and-file employees generally receive pay increases under the terms of collective bargaining agreements with the administration that are ratified by the Legislature.

OVERVIEW

The Governor's budget would increase state employee compensation costs by an estimated $1.2 billion in 2007-08. Item 9800 includes $972 million ($468 million General Fund) of this amount. The remainder is included in departmental budgets—principally the Department of Corrections and Rehabilitation. The vast majority of the funds address costs related to current labor agreements, court orders, and arbitration decisions. We withhold recommendation on the overall amount needed to fund 2007-08 compensation increases pending (1) outcomes of labor negotiations, (2) the April release of the inflation rate that will determine raises for most employees under current contracts, and (3) determination of next year's premium costs for state employee health plans.

Status of Bargaining Agreements. Nineteen of the state's 21 bargaining units—all except correctional officers and attorneys—have agreements that remain in effect until at least the end of 2007-08. Almost all of the funds for employee compensation increases in the Governor's budget reflect estimated costs related to (1) these 19 labor agreements and (2) court orders and arbitration decisions that have increased state costs. We estimate that the budget would increase civil service and judicial branch employee compensation costs by $1.2 billion in 2007-08—with around 55 percent of the increased costs to be paid from the General Fund.

Figure 2

State Civil Service General Salary Increases

1991-92 Through 2007-08

		Consumer Price Indices	
Fiscal Year	**Increase**	**United States**	**California**
1991-92	—	3.2%	3.6%
1992-93	—	3.1	3.2
1993-94	5.0%	2.6	1.8
1994-95	3.0	2.9	1.7
1995-96	—	2.7	1.4
1996-97	—	2.9	2.3
1997-98	—	1.8	2.0
1998-99	5.5	1.7	2.5
1999-00	4.0	2.9	3.1
2000-01	4.0	3.4	4.3
2001-02	—	1.8	3.0
2002-03	—	2.2	2.6
2003-04	—[a]	2.2	1.9
2004-05	5.0[a]	3.0	3.3
2005-06	—[a]	3.8	4.3
2006-07[b]	3.5[a]	2.1	3.1
2007-08[b]	3.3[a,c]	2.2	2.3

a Some bargaining units received salary increases different from those listed here. In particular, Unit 5 highway patrol officers, Unit 6 correctional officers, and Unit 9 engineers received increases in part tied to increases in salaries of other California workers. See Figure 3.

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

c Administration projection of change in the Consumer Price Index (West-Urban) for 12 months ending March 2007, which is the raise provided in most labor agreements.

Most Budget-Year Funds Are Included in Item 9800. In general, departmental budgets include the current costs of compensating state employees, including the pay raises for state employees that the Legislature approved in 2006. The Governor's budget provides for most scheduled increases in the cost of compensating state employees in Item 9800 (Augmentation for Employee Compensation). The budget proposes $972 million ($468 million General Fund) of expenditures in this item. Included in the item are several categories of compensation increases to take effect in 2007-08 (see Figure 3 on the next page).

Figure 3

Item 9800 Includes $972 Million of Increased Employee Compensation Costs

(In Millions)

	General Fund	Special Funds	Totals
General salary increases (GSIs) based on inflation	$132	$192	$324
Other GSIs	23	202	225
Correctional peace officer arbitration costs	114[a]	—	114
Health care pay raises—not including Corrections[b]	21	2	23
Health, dental, and vision benefits	53	74	127
Contingency	16	16	32
Other increases	109	17	127
Totals	**$468**	**$503**	**$972**

a Finance Letter received on January 19, 2007, adds $46 million to this amount.

b The cost of pay increases for health care workers in the Department of Corrections and Rehabilitation is included in its budget.

- The GSIs for employees in 15 state bargaining units tied to the inflation rate in the western United States for the 12 months ending in March 2007.
- The GSIs for employees in other units with agreements that remain in effect until at least the end of 2007-08—with most of these costs related to increases for engineers and California Highway Patrol (CHP) officers. (Figure 4 lists recent and budgeted increases for these two groups, which are based on surveys of salaries paid to employees in other California public agencies.)
- Additional budget-year costs related to a recent arbitration decision won by the California Correctional Peace Officers Association (CCPOA), which found that the state had miscalculated pay raises under the now-expired 2001-2006 CCPOA agreement. (Figure 4 shows the pay raises provided to correctional officers since 2003.)
- Proposed pay raises for health care personnel in departments other than CDCR.
- Projected increases in employee health, dental, and vision benefit costs, which will be driven largely by the 2008 rate increases set

by the California Public Employees' Retirement System (CalPERS) in June 2007.

- Over $32 million of contingency funds to cover any funding shortfall.
- Other pay increases, including $20 million for increased judges' pay required by existing law.

Figure 4

General Salary Increases for Highway Patrol, Correctional Officers, and Professional Engineers

	2003-04	2004-05	2005-06	2006-07	2007-08 (Budgeted)
Unit 5—Highway Patrol	2.7%	12.1%	5.6%	5.7[a]%	5.7%
Unit 6—Correctional Officers	6.8	10.3	8.4[b]	5.2[c]	—
Unit 9—Professional Engineers	—	5.0	4.0-7.7[d]	7.4-12.4[d]	10.0-12.6[d]

a Unit 5 members also received a 3.5 percent stipend beginning in 2006-07 as compensation for pre- and post-shift activities that are compensable under federal law.

b Includes 3.1 percent pay raise—retroactive to 2005-06—awarded to correctional officers by an arbitrator in January 2007.

c Includes 0.9 percent increase starting June 30, 2006 and a 4.3 percent increase starting July 1, 2006.

d Varies by class based on surveys of salaries of engineers employed by California public agencies.

Some Funds Included in Departmental Budgets. In addition to the $972 million of increased compensation items included in Item 9800, the Governor's budget also includes increased appropriations of around $200 million in various departmental line items for (1) salary increases for specific groups of employees in these departments and (2) possible increases in 2007-08 pension contributions. Around three-fourths of these increases in departmental budgets would be paid from the General Fund. The largest category of costs relates to anticipated 2007-08 pay increases to comply with court orders affecting the prison health care system.

Budget Includes Estimated Health Premium Increases. The Governor's budget includes $127 million ($53 million General Fund) for expected increases in the state's contributions to employee health, dental, and vision insurance premiums. (Since the state is negotiating with CCPOA for a new contract, no funds are included in the budget for an increase in correctional officer health premium contributions in 2007-08.) Under the terms of bargaining unit contracts, the state pays 80 percent to 85 percent of health care premiums for most employees. The CalPERS will set state employee health premium rates for calendar year 2008 in June 2007. Accordingly, the state's costs may be higher or lower than the administration has proposed depending on the size of the CalPERS premium increase.

Withhold Recommendation. The overall amount needed to fund 2007-08 employee compensation increases will depend on the outcomes of labor negotiations, the inflation rate—to be released in April—that will determine raises for most employees under current contracts, and the 2008 premium costs for state employee health plans. Given these uncertainties, we withhold recommendation on the overall amount needed in this budget item.

ADDITIONAL COSTS AS PRISON PAY SURGES

A Realistic Budget Plan Requires Decisions About Correctional Officer Pay

The labor agreement with the California Correctional Peace Officers Association expired in July 2006, and negotiations on a new agreement continue. For each percent salary increase in 2007-08 for the state's correctional officers, costs would rise by about $35 million above those in the Governor's budget. Therefore, we recommend that the administration provide an update on negotiations prior to the May Revision so that potential costs can be considered in the development of a realistic budget plan.

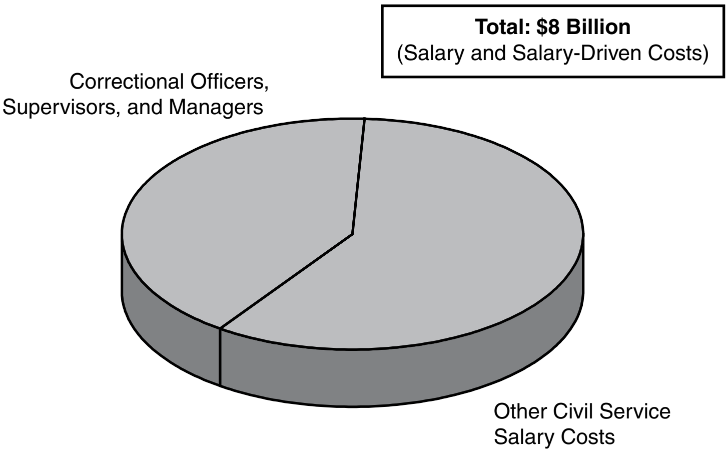
Decisions About Officer Pay Drive General Fund Personnel Costs. Figure 5 shows that salaries and related costs for the state's correctional officers were the key component of civil service personnel expenditures paid from the General Fund in 2005-06. These funds paid to correctional officers, their supervisors, and managers totaled $3.4 billion—41 percent of all such General Fund costs.

Correctional Officer Increases Outpace Other State Employees. Under a labor agreement that was adopted in 2001 and expired in 2006, correctional officers received pay increases far in excess of those given to most other state employees during this period. These increases were driven by a formula that considered the pay of local law enforcement officers in the state, as well as CHP officers. After factoring in the possible effects of a recent arbitration decision in favor of CCPOA (which we discuss later), we estimate that the officers' GSIs have increased their pay by 34 percent between 2002-03 and 2006-07. (Other compensation items, including retirement and health benefits and overtime, also have increased.) The average annual pay increases for correctional officers between 2002-03 and 2006-07 were more than twice as much as the increases for the average state government employee.

Figure 5

Correctional Officer Salaries Drive General Fund Personnel Expenditures

2005-06



Administration Should Provide an Update Prior to May Revision. In order to develop a realistic budget plan, the Legislature needs to consider potential costs for correctional officer compensation increases in 2007-08. We recommend, therefore, that the administration provide an update on negotiations prior to the May Revision. The box on the next page discusses what might happen if there is no agreement in place by the start of the fiscal year.

Arbitration Decision Raises Officer Pay Much More Than Expected

A recent binding arbitration decision determined that the state miscalculated the pay raises to which correctional officers were entitled in 2005-06 under the prior labor agreement with the California Correctional Peace Officers Association. The Governor's budget accounts for $240 million from the General Fund in the current and budget years to pay for this decision, including $114 million in 2007-08. The administration has submitted a Finance Letter to account for an additional $46 million in budget-year costs. An additional $154 million for 2005-06 and 2006-07 costs will be funded through other means, including a supplemental appropriations bill.

What Happens if There Is No CCPOA Agreement Before July 1?

Typically, Employees Receive No Increases After Agreements Expire. Under state law, when a collective bargaining agreement expires and the Legislature has not yet ratified a new agreement with a state employee bargaining unit, the provisions of the expired agreement generally remain in effect. Most agreements specify that employees will receive raises of specified percentages on specific dates during the contract's term. Therefore, when the agreements expire, there are typically no additional pay raises provided until the Legislature approves a new contract.

What Happens if There Is No Agreement Before July 1, 2007? The original 2001-2006 California Correctional Peace Officers Association (CCPOA) agreement listed specific dates of salary increases under the agreement, with the last date listed as July 1, 2006. Under the terms of an amended agreement ratified by the Legislature in 2004, the state received the benefits of short-term budget savings from foregone correctional officer pay in 2004-05 and 2005-06. The 2004 amendment provides that the CCPOA pay increase formula (which ties increases of correctional officer compensation to increases in California Highway Patrol (CHP) officer compensation) is "reestablished in full on July 1, 2006." It is unknown how this phrase might be interpreted in an arbitration or court proceeding. Once "reestablished," the formula may be a provision of the expired CCPOA agreement that remains in effect until there is a new agreement. *In this scenario,* when CHP officers receive a compensation increase on July 1, 2007, the state could be required to provide a pay raise to correctional officers at the same time. Under this scenario, this would likely be the case unless the Legislature explicitly chooses not to provide such compensation increases. The breadth of the recent arbitrator's decision increases the uncertainty about how the state's financial obligations under the contract may be interpreted.

Background. Under the pay formula in the prior CCPOA agreement, various correctional officer compensation items (collectively known as "total compensation") were tied to the total compensation of CHP officers. By July 1, 2006, the agreement required the state to increase each correctional officer's pay so that his or her monthly total compensation was no more than $666 below that of a CHP officer. Therefore, when CHP officer pay increased each year (based on a comparison of total compensation of CHP and local peace officers), so did the pay of correctional officers. The dispute between the administration and CCPOA that led to the arbitration proceeding had to do with whether the state should have included several categories of CHP officer compensation increases in 2005-06 in the correctional officer pay formula. The arbitrator determined that the state miscalculated the pay and benefit increases. Under this decision, the state must provide back pay to affected officers for 2005-06 and 2006-07 and adjust ongoing compensation beginning January 1, 2007.

Budgeted Costs Too Low. Since the arbitrator's decision was finalized after the release of the Governor's budget, the budget fails to include all of its costs. The total cost of the decision is $440 million. The proposed budget accounts for only $240 million in the current and budget years for these higher costs. The administration has submitted a Finance Letter to account for $46 million in additional 2007-08 costs. The remaining $154 million is for past and current-year costs to be funded through other means, including a supplemental appropriations bill.

Prison Health Care Cases Driving Pay Upward

Court orders have increased pay for clinicians and staff of the prison health care system significantly. This has produced a ripple effect, leading to increased pay for medical staff in other departments. We anticipate that compensation costs for health care personnel will increase much more over the next several years due to the prison court cases.

Court-Ordered Increases Have Greatly Increased Pay Levels. In the Criminal Justice chapter, we discuss the court orders that affect CDCR's medical, mental health, and dental care systems. While the cases have been litigated for years, several court orders since December 2005 have increased substantially the pay of clinicians within the prison health care system. The courts have ordered the pay increases to address widespread staffing shortages and concerns about the quality of health care personnel in CDCR. The court-designated receiver (who now manages CDCR's medical system), for example, now has the authority to double some CDCR doctors' base pay—to levels as high as $300,000 per year. Raises ordered by the courts have increased—or soon will increase—pay levels for many classifications by thousands of dollars per month. We estimate that the court orders already have increased prison health care pay by over $100 million annually. In addition, the proposed CDCR budget for 2007-08 provides for over $100 million in additional compensation costs expected to result from the court orders.

The Ripple Effect in Other Departments. Like CDCR, some of the state's other departments with medical staffs—such as the Department of Mental Health (DMH), the Department of Developmental Services (DDS), and the Department of Veterans Affairs (DVA)—historically have found it difficult to recruit and retain medical staff due to state salary levels being lower than those in the private sector and other factors. Since the recent round of CDCR court-ordered salary increases began in December 2005, these departments report that some clinical personnel and staff have left to work in CDCR for much higher salaries, and this has exacerbated existing recruitment and retention problems. In 2006-07, the Legislature approved the Governor's budget proposals and new labor agreements that extended sometimes double-digit pay increases to medical classifications outside of CDCR to prevent (1) excessive pay disparities between CDCR and other medical personnel and (2) declines in the quality of care offered by DMH, DDS, and DVA that could affect the health of individuals in state facilities and lead to federal or court sanctions for these departments. This year, the administration proposes to extend additional raises to some medical personnel in DMH, DDS, and DVA. In this item, the administration proposes $23 million ($21 million General Fund) for this purpose, and there is an additional $6 million General Fund included in DMH's proposed budget. Despite the pay increases implemented to date, the administration reports that its efforts to recruit new employees in these non-CDCR departments are "usually fruitless." Coping with vacancy rates that sometimes remain over 50 percent, the departments continue to rely on expensive contracted medical personnel. (These contractors, the administration reports, sometimes make two times or more the pay provided to the state employees in these facilities.)

Additional Increases Likely. The public statements by the receiver, the special master for prison mental health care, and others related to the court cases express continuing dissatisfaction with the quality and quantity of staffing in CDCR's health care system. While the receiver reports that the prisons have made some progress in recruitment, position vacancy rates—as reported by the State Controller's Office—do not appear to have declined substantially in CDCR health care personnel classifications despite the court-ordered pay increases. Meanwhile, other departments like DMH, DDS, and DVA report that their historical difficulties with recruitment and retention have been exacerbated due to the CDCR court-ordered pay raises. These facts suggest that court orders may continue to increase pay for CDCR health care personnel and that there may be a need to increase medical personnel pay in DMH, DDS, and DVA even further. (In particular, additional raises may be requested soon for DMH mental health clinicians not working in prison facilities.) Each request for a new round of pay raises from either the courts or the administration could increase General Fund costs above those in the Governor's budget by tens of millions of dollars.

OTHER ISSUES

Lower Inflation Rate May Reduce Costs in Governor's Budget

The administration assumes that most state employees will receive a 3.3 percent pay increase in 2007-08 under current labor agreements. We believe the actual inflation rate that determines this raise (to be released in April 2007) will be lower—an estimated 2.3 percent.

2006 Contracts Included Inflation-Based Raise for 2007-08. The contracts with Service Employees International Union Local 1000 and other bargaining units that were approved by the Legislature in 2006 generally provide state employees with an inflation-based raise for 2007-08. The raise is based on a specific federal price index, which will be released in April 2007. The administration assumes the index will result in a 3.3 percent raise for affected bargaining units. We currently estimate, instead, that it will result in a 2.3 percent raise. Under our estimate, state costs would be lower by about $100 million ($40 million General Fund). We expect the administration to include a revised budgeted figure for these costs in the May Revision based on the final index data.

Legislature Should Not Put Contingency Funds in Item 9800

The Governor's budget includes more than $32 million ($16 million General Fund) in a contingency fund in case the administration has miscalculated the amounts of added compensation to be provided. The budget, however, includes funds for unanticipated expenses in another line item. We recommend that the Legislature reject the proposed contingency fund in Item 9800 because it may allow the administration to raise pay of employees without legislative review. (Reduce Item 9800-001-0001 by $16,400,000. Reduce Items 9800-001-0494 and 9800-001-0988 by a combined amount of $16,100,000.)

The Pay Raise Process and the Use of Item 9800 Moneys. The state provides raises to (1) rank-and-file employees through collective bargaining agreements and (2) managers, supervisors, and exempt appointees of the administration through changes in salary and benefit schedules approved by the Department of Personnel Administration. Under state law and past practice, the Legislature has allowed the administration to exercise broad powers to set pay and benefit levels for non-represented employees. Funds appropriated in Item 9800 are distributed by the Department of Finance to departments during the budget year in order to fund the increases established through these processes. In the Governor's budget and with each proposed labor agreement submitted to the Legislature, the administration uses state payroll data to make a detailed estimate of how costly state employee pay and benefit increases will be. This estimate—like any other amount included in the state budget—sometimes will be different from actual costs.

Proposal Would Give Administration Too Much Power. We recommend against including contingency funds in Item 9800. These funds may allow the administration to raise pay of employees—particularly non-represented employees (including exempt appointees)—without legislative review. In addition, the budget includes funds for unanticipated expenses in another line item (Item 9840). If the administration determines that its calculations were incorrect, it should use the existing unanticipated expense process. If the administration knows of raises that it wants to give to state employees, it should propose funding for those raises through the regular budget process or the collective bargaining process. We therefore recommend that the Legislature reduce this item by $32 million.

RETIREMENT CONTRIBUTIONS
(CONTROL SECTION 3.60)

This control section specifies the state's contribution rates for the various retirement classes of state employees in the California Public Employees' Retirement System (CalPERS). The section also allows the Director of Finance to adjust amounts in any appropriation item as a result of changes in the contribution rates.

The State Constitution gives retirement boards, such as the CalPERS Board of Administration, the exclusive power to undertake actuarial reviews of their pension funds and to administer the funds for the benefit of their members. In order to fund defined monthly benefits for retired public employees, CalPERS uses (1) returns generated from its $224 billion investment portfolio and (2) contributions made by public employees and employers. Employees and retirees of the state and many local governments are enrolled in CalPERS' programs, with the assets and liabilities of each employer accounted for separately. Of the $26.6 billion unfunded liability for CalPERS' Public Employees' Retirement Fund as of June 30, 2005, for example, $14.8 billion represents unfunded liabilities attributable to the state. Local governments and school districts are responsible for the other liabilities. As a whole, the system's liabilities are 87 percent funded.

State law and collective bargaining agreements define the retirement benefits that state employees earn as part of the compensation provided in exchange for their work. The law and collective bargaining agreements require that employees pay a specified percentage of their salaries—typically about 5 percent or 6 percent—to CalPERS to cover a part of the costs of future pension benefits. The state also makes employer contributions to CalPERS. The employer contributions cover the estimated cost of pension benefits earned by employees in each pay period (normal cost), as well as costs to amortize and eliminate (over time) any unfunded liabilities that exist with regard to employees' and retirees' prior service. In defined benefit pension programs, such as those of CalPERS, unfunded liabilities emerge when actuarial assumptions related to annual investment returns, employee pay levels, and demographic factors are not met. Since these trends cannot be predicted with precision, CalPERS contribution rates usually change from year to year—sometimes increasing and sometimes decreasing.

Projected State Contribution Rates Down, Except for Peace Officers and Firefighters

Because of healthy investment returns, the California Public Employees' Retirement System (CalPERS) projects that required state contribution rates will decline slightly for most state employee groups in 2007-08 after unexpectedly increasing in 2006-07 due to several non-investment-related actuarial factors. The system's projection appears reasonable. Nevertheless, we withhold recommendation on 2007-08 contribution rates pending their final determination in May by the CalPERS Board of Administration based on the system's annual actuarial valuation.

Healthy Investment Returns May Help Reduce Rates for Most Groups. The CalPERS will set 2007-08 rates based on an actuarial valuation of the system's financial condition as of June 30, 2006. In 2005-06, the investment return of CalPERS' assets totaled about 12 percent, compared to the system's normal projected investment return of under 8 percent annually. This healthy investment performance was led by a (1) 38 percent return on the system's real estate investments, (2) 27 percent return on international stocks, (3) 19 percent return on private equity investments, and (4) the system's 10 percent investment return on domestic stocks. These investment returns are the principal factors resulting in projected lower contribution rates for most state employee groups in 2007-08, as shown in Figure 1. More than one-half of the state's total contributions is for "Miscellaneous Tier 1" employees, and another one-fourth is for peace officers (such as correctional officers) and firefighters.

Employer Rates for Correctional Officers and Firefighters May Rise. The system's projections shown in Figure 1 indicate that the state's contribution rates for peace officers and firefighters will increase from 24.5 percent of payroll in 2006-07 to 25.6 percent in 2007-08. (This would be the highest state contribution rate for the peace officer and firefighter [POFF] retirement group in its 23-year history.) Enhanced "3 percent at 50" retirement benefits took effect for correctional officers and firefighters on January 1, 2006. Since the upcoming valuation will reflect the system's financial status as of June 30, 2006, it is the first such review to reflect the costs of the enhanced benefits. For the POFF retirement group, therefore, the increased costs of addressing liabilities related to the enhanced benefits are expected to outweigh the benefits of the favorable investment returns of 2005-06. The system projects that the state will make employer contributions of $755 million in 2007-08 for POFF group members. Most POFF group members work in departments that receive virtually all of their funding from the General Fund. The estimated 2007-08 POFF employer contributions equal about 50 percent of total projected General Fund-supported contributions to CalPERS in 2007-08.

Figure 1

State Retirement Contribution Rates

1991-92 Through 2007-08 (As Percent of Payroll)

Fiscal Year	Misc. Tier 1	Misc. Tier 2	Industrial	Safety	Peace Officer/ Firefighter	Highway Patrol
1991-92	11.8%	4.0%	13.4%	17.4%	17.4%	21.7%
1992-93	10.3	3.4	12.0	15.7	15.6	17.1
1993-94	9.9	5.0	11.8	15.5	15.2	16.9
1994-95	9.9	5.9	10.6	13.9	12.8	15.6
1995-96	12.4	8.3	9.0	14.2	14.4	14.8
1996-97	13.1	9.3	9.3	14.7	15.4	15.9
1997-98	12.7	9.8	9.0	13.8	15.3	15.5
1998-99	8.5	6.4	4.6	9.4	9.6	13.5
1999-00	1.5	—	—	7.5	—	17.3
2000-01	—	—	—	6.8	2.7	13.7
2001-02	4.2	—	0.4	12.9	9.6	16.9
2002-03	7.4	2.8	2.9	17.1	13.9	23.1
2003-04	14.8	10.3	11.1	21.9	20.3	32.7
2004-05	17.0	13.2	16.4	20.8	23.8	33.4
2005-06	15.9	15.9	17.1	19.0	23.6	26.4
2006-07	17.0	16.8	17.9	19.3	24.5	31.5
2007-08[a]	16.8	16.5	17.7	19.1	25.6	31.1

[a] California Public Employees' Retirement System estimates.

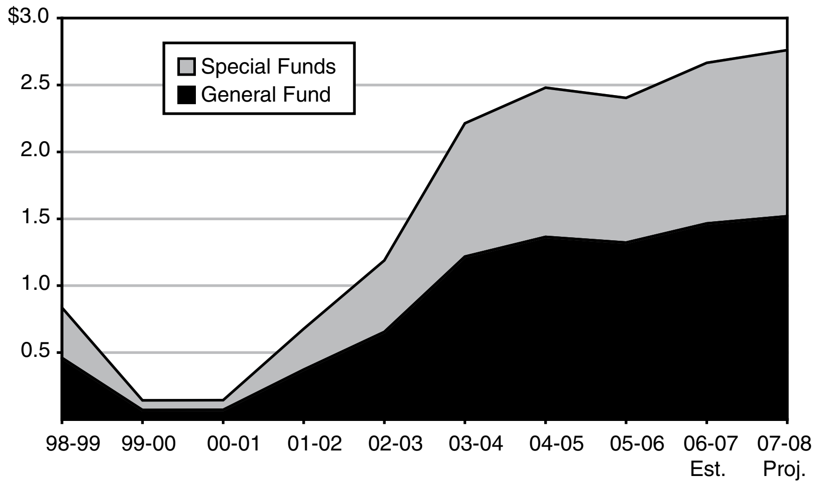
Total State Contributions Should Rise, Due to Larger Payroll. While required employer contribution rates are projected to decline for all of the retirement groups except POFF, the state's total contributions should increase due to payroll growth. Figure 2 (see next page) shows recent trends in the state's total contributions from the General Fund and special funds, including CalPERS' projections for 2007-08 contributions. Under these projections, total state contributions would grow from $2.7 billion in 2006-07 to $2.8 billion in 2007-08, up 3.6 percent. Over one-half of this amount (an estimated $1.5 billion) would be paid from the General Fund. The *2007-08*

Governor's Budget accommodates virtually all of these costs. Should CalPERS' current projections hold, we estimate that about $10 million may need to be added to the Governor's budget in order to address higher General Fund costs than are currently reflected in various line items.

Figure 2

State Retirement Contributions to CalPERS

(In Billions)



Withhold Recommendation. The projections provided by CalPERS appear reasonable. Nevertheless, we withhold recommendation on the control section pending CalPERS' final determination of required 2007-08 contribution rates—which is expected to occur in May. The administration should be able to submit any necessary revisions in budgeted amounts related to the new contribution rates in the May Revision or soon thereafter.

Doubtful That $525 Million Will Be Realized From Pension Bonds

The Governor's budget assumes that pension obligation bonds authorized in 2004 will be sold in 2007-08, yielding $525 million of net General Fund savings. In November 2005, a court found that the legislation authorizing the sale of the bonds was unconstitutional. Even if appellate courts were to overturn the superior court ruling, it

is risky to assume that the sale of the bonds could be completed in the budget year.

Chapter 215, Statutes of 2004 (SB 1106, Committee on Budget and Fiscal Review), authorizes the sale of up to $2 billion in pension obligation bonds. (This bill was passed after a similar 2003 law was challenged in court.) Legal rulings also have prevented the sale of the bonds authorized by Chapter 215. The administration now assumes that (1) its efforts to overturn the 2005 superior court ruling in appellate courts will succeed, (2) the case will be finalized—meaning that all appeals by all parties are exhausted—during the budget year, (3) the bonds can be successfully marketed to investors in time to generate a net benefit for the General Fund for the budget year, and (4) the amount of bond proceeds—limited under the law by an arcane formula—will be sufficient to generate $525 million of net General Fund savings. We believe it is unlikely that all four of these assumptions will be met during the budget year, if ever.

Even if the bonds could be sold in 2007-08, we would advise on a policy basis not to proceed with a sale. We have consistently recommended against issuing the bonds since they would incur debt for an annual operating expense. In addition, the proposed issuance of the pension obligation bonds runs counter to the budget's stated goal of reducing budgetary debt.

MIDYEAR BUDGET REDUCTIONS (CONTROL SECTIONS 4.04 AND 4.05)

These control sections provide the administration with authority to reduce departmental General Fund appropriations during the year, after the budget is enacted. In total, the administration assumes that these control sections will reduce state General Fund expenditures by $146 million in 2007-08. Specifically:

- ***Control Section 4.04—Inflation Adjustment for Operating Expenses.*** After the release of the January 10 budget, the administration requested the addition of this section to the budget bill. The administration's revised budget assumes $46 million in savings from reducing by one-half the inflation adjustment for operating expenses built into departmental budgets. (That is, a 2.7 percent adjustment would be reduced to 1.35 percent.) Two-thirds of the savings are proposed to come from the California Department of Corrections and Rehabilitation (CDCR). Reductions would be made "only to the extent necessary to ensure that there is no net operating deficit in 2007-08."
- ***Control Section 4.05—One-Time Reductions.*** The budget assumes $100 million in one-time savings from this section. A state operations appropriation could not be reduced by more than 20 percent, and a local assistance appropriation could not be reduced by more than 5 percent.

Delete Sections for More Honest Budgeting

The proposed control sections are unlikely to achieve their targeted levels of savings. In addition, they represent a significant delegation of the Legislature's authority. Consequently, we recommend that the Legislature delete the sections from the budget bill. (Delete Control Sections 4.04 and 4.05.)

Reductions Reflect Administration's—Not Legislature's—Priorities. Any unallocated reduction authority given to the administration will expose legislative priorities to reductions. An administration naturally will protect its own priorities and sacrifice programs that it deems less important. For example, in the health area, previous reductions have targeted a prostate cancer treatment program and Medi-Cal antifraud activities—both of which were priorities of the Legislature.

Savings Already Counted. Over the past few years, the state budget has included a variety of control sections similar to the ones proposed for 2007-08. Based on recent experience, we estimate that only a fraction of the assumed budget savings would be a *net* benefit to the state's bottom line. For instance, in 2006-07, $132 million of the $200 million in savings attributed to Control Section 4.05 was from declining debt service on loans and general obligation bonds. Another $24 million was attributed to lower-than-expected usage of a health program. These types of savings are captured on the natural in the "unidentifiable savings" category of the budget. When these types of savings are instead scored under a control section, the practical effect is to reduce the unidentifiable savings item on a dollar-for-dollar basis. The budget, however, assumes the state will still achieve unidentifiable savings in 2007-08 ($340 million).

Other Cuts Will Lead to Future Shortfalls. Many of the midyear reductions that have been implemented in the past have been done with minimal detail provided to the Legislature as to how departments are going to absorb the reductions. Often months or years later, the Legislature discovers that programs that were reduced are no longer functioning as expected. In many of these cases, departments come forward with requests for additional funding in the same or future years to make up for the reductions. For example, the 2007-08 budget contains a $3.2 million request from the Department of Veterans Affairs for equipment purchases. The department reports its entire equipment budget was eliminated through reductions in prior years. Similarly, it is unclear how CDCR will absorb a $31 million reduction in 2007-08 through Control Section 4.04—given that the department has experienced budget shortfalls of more than $100 million every year since 2000-01.

Recommend Deleting Control Sections. Given recent experience with similar control sections and the loss of legislative authority they require, we recommend that both sections be deleted from the budget bill. The administration should identify any *specific* proposed savings in departmental budgets during the spring budget process and how it expects these savings to be achieved. This would allow the Legislature to understand any programmatic impact from the reductions and protect its own priorities. Moreover, if the administration desires to make appropriation changes once the budget is enacted, it can seek statutory changes.

FINDINGS AND RECOMMENDATIONS

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Crosscutting Issues

Implementation of the Housing Bond

F-13 ■ **Implementation of the Housing Bond.** In November 2006, voters approved Proposition 1C, which allows the state to sell $2.85 billion in general obligation bonds to fund existing housing programs as well as new programs that encourage housing developments. Recommend statutory and administrative measures to ensure effective implementation of the bond program.

Governor's Office

F-25 ■ **Reject Autopilot Spending. Reduce Item 0500-001-0001 by $356,000.** Recommend rejecting the administration's proposal to increase the Governor's Office budget annually on an automatic basis.

Office of the Chief Information Officer (CIO)

F-28 ■ **Information Technology (IT) Governance Changes.** The administration proposes a number of changes to the state's information technology (IT) governance structure. Our analysis finds that (1) the planning and policy development roles are appropriately placed with the CIO, (2) moving IT project oversight to CIO would eliminate objectivity, and (3) a separate security office may create an unnecessary layer of review. We recommend the Legislature adopt an alternative structure that addresses these concerns.

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Office of Emergency Services

F-34 ■ **Port Security Proposal Ignores Availability of Bond Funds.** Delete Item 0690-111-3034. Recommend deleting a $5 million proposal for port security grants from the Antiterrorism Fund. Recently approved bond funding provides $100 million for the same purpose.

F-35 ■ **Bond Programs Need Framework.** Recommend the Legislature provide more specific statutory frameworks for the port and transit security grant programs funded by the recent transportation bond. Recommend the funds be distributed competitively in a manner which provides long-term benefits and leverages other funds.

F-37 ■ **Open-Ended Request Lacks Specificity.** Delete Item 0690-001-8039. Recommend rejecting a proposal for open-ended spending authority for public-private partnerships on emergency preparedness. Once it begins to receive donations, the administration should present a specific spending proposal.

F-38 ■ **Consulting Contracts Unnecessary.** Reduce Item 0690-001-0001 by $1,075,000. Recommend deleting General Fund requests for consulting contracts to prepare various reports and perform other activities. Departmental staff should be able to perform the work without the added costs.

Board of Equalization (BOE)

F-40 ■ **Position Request Not Justified. Reduce item 0860-001-3065 by $230,000.** We recommend the Legislature reduce the board's proposed position authority by 6 personnel years and $230,000 due to reduced workload in the electronic waste recycling program. (Reduce item 0860-001-3065 by $230,000.)

F-41 ■ **Revenue Estimate From Enforcement Work Scored Too Low.** We recommend the Legislature score an additional $800,000 in General Fund revenues due to various enhancements to BOE's Consumer Use Tax Section proposed by the administration.

F-42 ■ **Electronic Filing Should Generate Savings.** We: (1) withhold recommendation on the administration's request for two positions and $1,460,000 ($949,000 General Fund and $511,000 reimbursements) for electronic filing infrastructure enhancements, and (2) recommend that BOE report at budget hearings regarding the status of efforts to develop a cost-savings model, together with estimates of medium- and long-term savings and costs associated with increased conversion to electronic systems.

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Secretary of State

F-48 ■ **Progress Report on Source Code Review.** Recommend an update at budget hearings on source code review. No funds were spent through the first half of the year.

F-48 ■ **Begin Ramping Down Administrative Costs. Reduce Item 0890-001-0890 by $308,000.** Reduce administrative expenses to reflect the reduction in Help America Vote Act activities in the budget year.

Department of Consumer Affairs

F-50 ■ **Reform of the Bureau of Private Postsecondary and Vocational Education.** Withhold recommendation pending receipt and review of the proposed legislation and workload analysis.

Franchise Tax Board (FTB)

F-56 ■ **Recommend Reallocation of Tax Gap Efforts.** Recommend that the Legislature redirect some proposed budget-year spending on tax gap activities in order to increase their payoff in terms of General Fund revenues.

F-57 ■ **E-Services Save Time and Money. Reduce Item 1730-001-0001 by $500,000.** Recommend that FTB's budget be reduced to account for savings associated with increased use of business-entity electronic return processing, electronic remittance processing, and associated reductions in the amount of paper printing and mailings.

F-58 ■ **Customer Service Level Deficiency Is Seasonal. Reduce Item 1730-001-0001 by $724,000.** Recommend that the Legislature reduce the augmentation for FTB's Contact Centers by $724,000 (General Fund) because it does not provide adequate justification for the higher permanent staffing level.

F-59 ■ **Delete Augmentation of Legal Support for Abusive Tax Shelters (ATS). Reduce Item 1730-001-0001 by $1,330,000.** Recommend that the Legislature delete $1,330,000 and ten positions from the administration's request to provide additional legal support for ATS workloads.

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Department of General Services

F-62 ■ **Withhold Recommendation on Radio System Pending Report.** We withhold recommendation on a proposed expenditure authority increase of $4.9 million for costs associated with the California Highway Patrol's Enhanced Radio System pending the delivery of a March 1 annual report.

California State Teachers' Retirement System

F-65 ■ **System's Funded Status Is About Average for Comparable Pension Systems.** The most recent California State Teachers' Retirement System (CalSTRS) actuarial valuation reported that the system's unfunded liability declined from $24 billion in 2004 to $20 billion in 2005. Measured as a percentage of the system's total liabilities, this unfunded liability is about average among comparable public pension systems. The Teachers' Retirement Board has formulated a general proposal for the Legislature's consideration, which would attempt to address the unfunded liability.

F-67 ■ **State's Loss of Lawsuit Would Require Payment of Over $650 Million.** Recommend that the Legislature consider funding a possible court-ordered payment obligation from General Fund reserves if possible. If reserves of this size are not available, recommend that the Legislature consider borrowing options with the lowest overall interest costs.

F-68 ■ **Reject Plan to Guarantee Teacher Benefit.** Recommend rejecting the administration's proposed trailer bill language to (1) guarantee teachers' purchasing power benefits through CalSTRS and (2) reduce General Fund costs by $75 million. There are risks in assuming that the change proposed in the budget package will generate savings, and we are concerned about the idea of the *state* guaranteeing another benefit through CalSTRS, which serves employees of *local* districts.

Department of Corporations

F-71 ■ **State Corporations Fund: Legislative Oversight Needed.** Withhold recommendation on the department's budget pending a report at budget hearings on its plan to reduce its fees and the fund balance in the State Corporations Fund pursuant to current law.

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Housing and Community Development

F-73 ■ **Designate Lead Department for New Program. Reduce Item 2240-001-6071 by $685,000. Reduce Item 2240-101-6071 by $30,000,000. Augment Item 3790-101-6071 by $30,000,000.** Recommend designating the Department of Parks and Recreation as the administrator for the Housing Urban-Suburban-and-Rural Parks program because doing so would result in lower overall state administrative costs, more consistent project evaluation and better coordinated project selection, than if two agencies administer separate grant programs for park development.

F-75 ■ **Specify Funding Amount for Parks.** Recommend the enactment of legislation to specify what portion of the $850 million from the Regional Planning, Housing and Infill Incentive program should be allocated to parks.

Employment Development Department

F-76 ■ **Budget Proposes Reduction in Job Services Program.** We withhold recommendation on this proposal because supporting information on this reduction was not available at the time this analysis was prepared.

F-77 ■ **Workforce Investment Act (WIA) Discretionary Funds.** We provide a comparison of proposed expenditures within the categories to the prior year and recommend the redirection of $3.4 million WIA funds to offset General Fund costs in parolee employment programs.

Department of Finance

F-81 ■ **Financial Information System.** The Legislature will need to weigh the potential benefits of a statewide financial system against its tremendous costs ($1.3 billion). We discuss key issues the Legislature should consider in evaluating the project and make recommendations for additional oversight tools if the Legislature decides the project should go forward.

Commission on State Mandates

F-92 ■ **Inconsistency Between Budget Funding and Government Code.** Recommend the administration either propose funding to pay local governments' mandate bills in 2007-08 (about $150 million) or propose legislation to modify the Government Code to reflect the administration's delayed payment schedule.

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F-93 ■ **No Proposal Regarding Three New Mandates.** Recommend the Department of Finance clarify its budget proposal regarding three of the four mandates recently identified by the commission.

Military Department

F-96 ■ **Tuition Assistance Program Duplicates Purpose of Existing Program. Reduce Item 8940-001-0001 by $1,699,000.** Recommend rejecting request to establish a Tuition Assistance Program to aid in recruitment. This request duplicates the purpose of another financial aid program established in 2003.

Department of Veterans Affairs and Veterans' Homes of California

F-98 ■ **Awaiting Plan for Equipment Budget.** Withhold recommendation on a General Fund request for $3.2 million for ongoing maintenance and equipment replacement pending the receipt of a comprehensive plan.

F-99 ■ **Staff Request for New Homes Overly Aggressive. Reduce Item 8967-001-0001 by $374,000.** Recommend a $374,000 reduction to a request to hire staff for new Southern California homes given opening of the first two homes is more than 18 months away from the start of the budget year.

F-100 ■ **Operating Expense Baseline Adjustment Faulty. Reduce Item 8960-001-0001 by $334,000; Item 8965-001-0001 by $32,000; Item 8966-001-0001 by $336,000.** Reduce request by $702,000 to reflect faulty calculations in determining cost increases.

Health and Dental Benefits for Annuitants

F-103 ■ **Administration's Estimates Appear Too Optimistic.** Withhold recommendation on the request for $1.14 billion for retiree health and dental costs pending the determination by the California Public Employees' Retirement System (CalPERS) of calendar-year 2008 health premiums in May or June. Given the recent track record of the CalPERS Board of Administration concerning premium increases, we doubt that costs will remain within the budget assumptions.

F-105 ■ **Valuation of Retiree Health Unfunded Liabilities Should Be Released This Year.** Continue to recommend that the Legislature (1) begin to set aside money to address future state retiree health costs and (2) require improved disclosure of unfunded retiree

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health liabilities by local governments, including school districts. We continue to estimate that the state's unfunded liability for retiree health benefits is between $40 billion and $70 billion. A new 12-member commission to be appointed by legislative leaders and the Governor is expected to consider issues concerning public employee retiree health and pension systems during 2007.

F-107 ■ **Approve Plan to Use Medicare Employer Funds for Retiree Health Costs.** Recommend that the Legislature approve the administration's proposal to use an estimated $38 million of Medicare Part D employer subsidy funds received in 2006-07 to pay a small portion of 2007-08 state costs for retiree health benefits. If the proposal is not approved, then General Fund costs would increase by $38 million.

Employee Compensation

F-110 ■ **Overview.** Withhold recommendation on the overall amount needed to fund 2007-08 compensation increases pending (1) outcomes of labor negotiations, (2) the April release of the inflation rate that will determine raises for most employees under current contracts, and (3) determination of next year's premium costs for state employee health plans.

F-114 ■ **A Realistic Budget Plan Requires Decisions About Correctional Officer Pay.** Recommend that the administration provide an update on negotiations with correctional officers prior to the May Revision so that potential costs can be considered in the development of a realistic budget plan.

F-115 ■ **Arbitration Decision Raises Officer Pay Much More Than Expected.** A recent binding arbitration decision determined that the state miscalculated the pay raises to which correctional officers were entitled in 2005-06 under their prior labor agreement. The Governor's budget accounts for $240 million from the General Fund in the current and budget years to pay for this decision, including $114 million in 2007-08. The administration submitted a Finance Letter to account for an additional $46 million in budget-year costs. An additional $154 million for 2005-06 and 2006-07 costs will be funded through other means, including a supplemental appropriations bill.

F-117 ■ **Prison Health Care Cases Driving Pay Upward.** Court orders have increased pay for clinicians and staff of the prison health care system substantially. This has produced a ripple effect and led the Legislature to increase pay for medical staff in other departments.

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We anticipate that compensation costs for health care personnel will increase much more over the next several years due to the prison court cases.

F-119 ■ **Lower Inflation Rate May Reduce Costs in Governor's Budget.** The information needed to estimate the costs for inflation-based pay raises for many state employees will not be released until April 2007, but we believe that the actual inflation rate will be lower than assumed in the Governor's budget.

F-119 ■ **Legislature Should Not Put Contingency Funds in Item 9800. Reduce Item 9800-001-0001 by $16,400,000. Reduce Items 9800-001-0494 and 9800-001-0988 by a combined amount of $16,100,000.** Recommend that the Legislature reject a proposed contingency fund in Item 9800 because it may allow the administration to raise pay of employees without legislative review.

Retirement Contributions

F-122 ■ **Projected State Contribution Rates Down, Except for Peace Officers and Firefighters.** Withhold recommendation on the 2007-08 California Public Employees' Retirement System pension contribution rates pending final determination of the rates in May based on an annual actuarial valuation.

F-124 ■ **Doubtful That $525 Million Will Be Realized From Pension Bonds.** The Governor's budget assumes that pension obligation bonds authorized in 2004 will be sold, yielding $525 million of net General Fund savings in 2007-08. In November 2005, a court found that the legislation authorizing the sale of the bonds was unconstitutional. Even if the appellate courts were to overturn the superior court ruling, it is risky to assume that the sale of the bonds could be completed in the budget year.

Midyear Budget Reductions

F-126 ■ **Delete Midyear Budget Reduction Authority. Delete Control Sections 4.04 and 4.05.** Recommend deleting control sections from the budget that allow the administration to make midyear reductions to appropriations. These types of sections rarely achieve the intended savings and undermine the Legislature's authority and priorities.