Senate Budget and Fiscal Review— Mark Leno, Chair

SUBCOMMITTEE NO. 4 Agenda

Senator Richard Roth, Chair

Senator Janet Nguyen
Senator Richard Pan

Thursday, March 26, 2015
9:30 a.m. or Upon Adjournment of Session
Rose Ann Vuich Hearing Room 2040

Consultant: Mark Ibele

Agenda

State Finance and Tax Administration

- **Department of Finance**
- **Legislative Analyst's Office**

<u>Discussion / Vote Calendar</u>

Item for Discussion

Oversight—Tax Compliance and Enforcement and the Underground Economy

Presentation: **Franchise Tax Board**
Board of Equalization
Little Hoover Commission

Comments: **Legislative Analyst's Office**

BACKGROUND

Compliance and Enforcement. The state has two principal tax collection agencies that administer revenue programs that benefit the state General Fund and various special funds:

- Franchise Tax Board (FTB) administers and collects the personal income tax (PIT) and the corporation tax (CT).

- Board of Equalization (BOE) administers and collects the sales and use tax, various excise taxes, and other taxes and fees.

As part of their administrative duties, the agencies operate extensive programs designed to (1) assist taxpayers in complying with the state's tax laws and (2) impose enforcement mechanisms in the event of non-compliance. The tax agencies are required to submit annually to the Joint Legislative Budget Committee (JLBC) extensive information on their compliance and enforcement activities. These activities for each of the agencies are outlined below:

The BOE efforts in compliance and enforcement encompass the following programs:

- **Audit Program.** The audit program is designed to ensure businesses report neither more nor less tax than required by law. The audit program operates on a three-year cycle and is designed to include the largest taxpayers and other accounts that maximize resource productivity. In 2013-14, net revenues (deficiencies less refunds) of the program were $463.6 million with a benefit-cost ratio of 4.1 to1.

- **Consumer Use Tax.** The consumer use tax section of BOE works closely with state and federal officials in administering the use tax due on non-dealer sales of vehicles, vessels, aircraft and mobile homes. In 2013-14, revenues of the program were $46.9 million with a benefit-cost ratio of 5.7 to1.

- **Collection Program.** The collection program collects on outstanding tax amounts owed using a collection model designed to maximize revenue per dollar of resources. In 2013-14, collection revenues were $686.9 million with a benefit-cost ratio of 13.1 to1.

- **Return Analysis.** The return analysis unit investigates discrepancies, creates billings, and makes other adjustments to tax returns as warranted. Returns are selected for review based on a matrix of information, including business type, taxpayer location, computational rules, thresholds and variances. In 2013-14, the program generated revenues of $48.1 million for a benefit-cost ratio of 11.7 to1.

- **Compliance Enforcement.** Compliance enforcement encompasses several programs designed to identify non-filers and under-reporters. In 2013-14, the program billed revenues of $138.7 million for a benefit-cost ratio of 4.4 to1.

The FTB implements programs that are similar to the BOE's, although they address issues that are particular to the taxes that it administers, specifically:

- **Accounts Receivable Management Program.** This collection program involves collection of accounts that the department establishes by its self-assessment, audit, and filing enforcement activities. The program includes the Statewide Collection Bureau, Personal Income Tax Billing, Compliance and Collection Bureau, Business Entity Collection Bureau, Field and Complex Account Collection Bureau, Special Programs Bureau, and Advisory, Analysis and Services Bureau. In 2013-14, the program generated revenues of $2.9 billion with a benefit-cost ratio of 14 to1.

- **Audit Program.** The audit program includes the National Business Audit Bureau, Individual & Pass-Through Entity Audit Bureau, Audit Protest and Administration Bureau, and Technical Resource and Services Bureau. The primary responsibility of the program is to conduct examinations of taxpayer income tax returns, determine the correctness of self-assessed liabilities, issue notices of proposed assessment, and resolve taxpayer disputes. In 2013-14, the program generated revenues of $1.4 billion for a benefit-cost ratio of 7 to1.

- **Filing Compliance Program.** The department's filing compliance efforts fall into activities related to filing enforcement, non-wage withholding, and fraud and discovery. In 2013-14, the program billed revenues of $2.5 billion for a benefit-cost ratio of 57 to1.

- **Tax Return Validation.** The tax return validation program amends and corrects routine mathematical discrepancies, complex taxpayer errors, incomplete returns, keying errors and validates e-file returns and payments. Perfection of tax returns is required prior to loading the data to main tax systems used by the department. In 2013-14, the program billed revenues of $1.6 billion for a benefit-cost ratio of 27 to1.

Tax Gap. The tax agencies compliance and enforcement programs address what is known as the 'tax gap.' The tax gap is defined as the difference between the amount of tax lawfully owed and the amount actually collected. The tax gap is the result of non-compliance with the state's tax laws, either through unintentional oversight, intentional disregard and outright active evasion. The presence of the tax gap puts an additional strain and burden on compliant taxpayers since, if all individuals and businesses complied, taxes for all compliant taxpayers could decline and still result in generating the same amount of revenue for the state. The tax gap, as defined by the tax agencies, is inclusive of those economic activities that are otherwise legal, but where compliance with the state's tax laws fails to occur.

Both BOE and FTB have estimated tax gap amounts over the last few years. The FTB estimates the current annual income tax gap to be $10 billion ($8 billion personal income tax and $2 billion corporation tax)—or roughly 15 percent of total taxes that should be collected from these sources. BOE estimates the current gap for taxes that it administers to be approximately $2.3 billion in lost revenues annually due to noncompliance, with General Fund reductions representing about $1.0 billion of this amount. The major components of the BOE portion of the tax gap are: (1) use tax liabilities of businesses and individual consumers; (2) tax evasion by non-filers; and (3) under-reporting and nonpayment by registered taxpayers. BOE and FTB have a number of initiatives that are specifically aimed at reducing the size of the tax gap in response to emerging issues in tax compliance.

BOE has had a tax gap strategic plan in place since 2007. In bringing the components of the plan into operation, BOE has initiated a number of specific programs above and beyond its regular compliance activities. Some of these are designed to increase voluntary compliance, and thus focus on education and outreach efforts to inform consumers and businesses regarding their tax collection and remittance obligations. In other cases, tax gap efforts are targeted more on the compliance and enforcement activities, such as the Statewide Compliance and Outreach Program (SCOP). BOE has a number of additional tax gap initiatives currently in place. These programs include more effective use of software applications, utilizing North American Industry Classification System (NAICS) codes, investigating misuse of resale certificates, and conducting special audits of auto auctions and gas stations. The results of these and other selected programs are shown in the following table:

Board of Equalization
Tax Gap Initiatives
(Dollars in Millions)

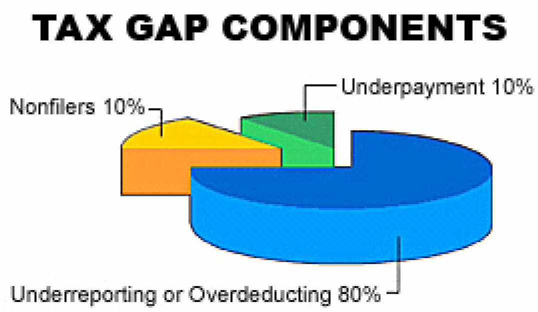
Tax Gap Program	2012-13 Actual Revenue	2013-14 Actual Revenue	2013-14 Benefit-Cost Ratio
US Customs	$13.0	$7.3	9.0:1
Agriculture Station Inspection	60.9	68.2	10.2:1
AB 4X 18 Qualified Purchaser	50.4	36.9	3.2:1
Statewide Compliance and Outreach	85.9	65.6	4.7:1
Instate Service	36.0	15.0	1.9:1
Tax Gap II	9.5	16.1	4.2:1
AB 155—Nexus	NA	387.3	121.0:1
Out of State 1032 Audits	28.9	*	NA
Enhancing Tax Compliance	140.5	*	NA

*No longer reported as individual programs.

FTB pursues various programs to narrow the tax gap. Some of these programs focus on taxpayer education and seek additional compliance from those who may not be aware of certain tax requirements. Other measures relate to enforcement efforts to improve compliance among individuals and businesses that chose not to comply with the state's tax laws. These measures result in additional revenue for the state that would otherwise not be received. Equally central to the core value of their collection practices is that such efforts make the tax system fairer to everyone by distributing the burden according to adopted laws.

In general, the efforts and programs of FTB are designed to address the following components of the tax gap:

- Non-filers—Entities that simply avoid filing required income tax forms.
- Under-reporters/Over-reporters—Entities that under-report the amount of income or over-report income deductions or tax credits.
- Non-Payers—Entities that file but do not remit tax owed.



Tax enforcement and compliance has become increasingly driven by information, data, and technology over the last couple of decades. The FTB processes more than 15 million personal income tax returns and one million business enterprise returns annually. Given the volume and complexity of tax returns, filings and programs, it has become imperative that the department remains current in information technology in order to access and exchange information. FTB's operations are heavily reliant on effective storage and use of data from a variety of sources, in order to maintain adequate compliance and enforcement activities. The FTB has made significant progress in this area, and this continues to be a focus of its activities (see discussion under EDR issue). These efforts can also have a positive impact on reducing the tax gap.

FTB's Tax Gap Action Committee (TGAC) identifies specific tax gap-related initiatives and recommends efforts to pursue remedial actions. Currently, TGAC's key initiatives are:

- Provide background information on the underground and illegal economies. Continue partnerships with California agencies to improve compliance with tax and related laws.

- Increase FTB's ability to identify fraudulent refund claims and prevent the issuance of erroneous refunds when the claim is the result of a thief using a real taxpayer's information to file a false claim.[1]

Underground Economy. The underground economy is defined as those activities where economic activities are not sanctioned by law and are in and of themselves illegal, as well as those activities that are legal, but fail to comply with certain state laws regarding health and safety or licensing or taxes. Thus, in terms of the revenue impacts of the underground economy, there is likely some overlap with the estimated revenue impacts attributed to the tax gap by the tax agencies. For example, FTB indicates an overlap of about 50 percent. The magnitude of the underground economy is most certainly in the multi-billions of dollars.

The Little Hoover Commission released its report on the underground economy on March 9, 2015. In the report, it took a narrower perspective on the underground economy than that put forth above, and limited its focus to those activities that are legal when all laws and regulations are followed and illegal when not. The commission last reviewed the underground economy 30 years ago, at which point it concluded, "…the state can and must do more to deter the growth of the underground economy and eliminate its activity in many areas." In the current study, the commission indicates that not enough has changed in this arena since the 1985 report, labeling the state's performance at controlling the underground economy as 'woeful.'

The commission cites several general areas where state efforts are lacking: centralized leadership; enforcement resources; statutory clarity and appropriate penalties; effective enforcement tools; local enforcement funding; enforcement personnel compensation equity; ease of compliance; and, incentives, education and outreach. The commission also developed 15 separate recommendations to improve the state's performance. Some of these recommendations—such as establishing an independent underground economy advisor—would have an indirect effect of tax compliance and enforcement. Other recommendations—such as standardizing the definition of independent contractor—could have more direct implications for the tax agencies and their work.

Staff Comments: The departments should provide background information to the committee regarding the status of tax gap efforts, and provide any updates from prior years. This update should include results from discreet programs as well as general successes in narrowing the tax gap through increased data sharing and advances in technological capabilities. The departments should outline, in particular, their progress in coordinating with other state agencies—as well as other states—in these activities. In addition, the departments should address whether there are additional steps that they should be taking, given the Little Hoover Commission report on the underground economy.

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[1] In a related refund issue, as part of the 2012-13 statutory language was proposed that would have imposed a penalty on certain erroneous refund claims. The language imposing a penalty on these erroneous refund claims, when there is no reasonable basis, was not approved, thus allowing non-compliant taxpayers the opportunity to play 'audit roulette.' The language would have provided additional conformity with federal law. The corresponding federal treatment imposes a penalty if a claim for refund is made for an excessive amount unless there is a reasonable basis for the claim. The proposal would have closed a loophole in the general accuracy-related penalty framework by imposing a penalty equal to 20 percent of the excessive amount.

The LAO should provide comments regarding the department's efforts in this regard and any additional measures that the department could take to improve compliance.

Items for Discussion / Vote

0860 Board of Equalization
7730 Franchise Tax Board

Department Overview and Budget Summary: The departments and their budgets are described in the stand-alone sections for each agency below.

Issue for Discussion:

Issue 1: Department of Finance Budget Letter 14-12, July 12, 2014.

Background: In July of 2014, the Department of Finance (DOF) issued instructions to agencies and departments setting forth parameters for the preparation of the 2015-16 budget. The letter indicated that the priorities for the Administration continue to be maintaining a structurally balanced budget that "…preserves critical state services and pays down debt and obligations…" The instructions direct departments and agencies to continue to control costs and limits their ability to submit Budget Change Proposals (BCPs) or Enrollment/Caseload/Population (ECP) policy changes to the following circumstances:

a) Statutory changes necessary for departments to manage within their budgets;
b) Expected changes in programs' ECPs;
c) Paying down state debts and liabilities;
d) Reducing deferred maintenance;
e) Existing or on-going information technology (IT) projects;
f) Existing or ongoing capital outlay projects;
g) Critical new capital outlay projects;
h) Cost-cutting measures or authorizing efficiencies;
i) Improved budgeting practices related to zero-based budgeting, or other measures.

DOF issued a similar letter in 2013, as part of its instructions for preparing the 2014-15 budget. The first such restrictions were imposed for 2011-12, with further restrictions (equivalent to those in BL 14-12) imposed for 2012-13.

Impacts of Budget Letter: The DOF directive relates to all state departments, including those not directly under the Governor's authority. Thus, the directive applies to both of the state's major tax agencies—which together are responsible for the administration of the state's major taxes: personal income tax, sales and use tax and corporation tax. Total General Fund revenues generated by these taxes (and collected by the agencies) are expected to exceed $110 billion in 2015-16. In anticipation of the 2014-15 budget, the Franchise Tax Board (FTB) submitted to its board a BCP that would have addressed the tax gap (as discussed above) by focusing on federal audit revenue agents reports (RARs), withholding services and compliance, and fiduciary e-File services. The proposal would have cost approximately $1.9 million annually, and generated revenues of $13.9 million in the initial year and $20.4 million annually, thereafter. When fully implemented, the benefit-cost of the program would be about 10 to 1. The proposal was approved by the FTB board but rejected by the Administration on the basis that it did not meet any of the circumstances set forth in BL 14-12, as indicated by DOF staff.

Staff requested the FTB to update their estimates for the 2015-16 budget year. FTB estimates that a similar proposal would require 18-19 permanent positions in the audit program and generate $13.9 million in year one and $20.4 million annually thereafter. FTB is currently analyzing the fiduciary e-File services relative to a potential component of the Enterprise Data to Revenue (EDR) project BCP. EDR is described more fully in an item below.

Staff Comments: Notwithstanding the rejection by DOF of the FTB's proposed tax gap measure, the proposed BCP would squarely meet the Administration's circumstantial test in that 1) additional revenues could pay down debts and liabilities (c above), and 2) not spending $1 to generate an additional $10 is *prima facie* evidence of inefficient tax program administration (h above). More fundamentally—ignoring the revenue impact—by not applying existing tax laws to non-compliant taxpayers, the state sends a message to compliant taxpayers that is likely to have a very corrosive impact on the overall effectiveness of the state's tax programs. During other recent periods of fiscal restraint, administrations typically have recognized this potential negative impact, and specifically exempted the tax agencies' compliance activities from budget directives that might otherwise have limited their effective enforcement of the state's tax laws. Finally, the long term implication of the DOF directive is likely to have a chilling effect on the efforts of both agencies to initiate compliance and enforcement measures in the future, further jeopardizing the effective enforcement of the state tax laws. Whether this has already occurred is not known.

Questions:

Franchise Tax Board and Board of Equalization

1. In addition to the BCP from FTB discussed above, are there other programs that have been developed by the tax agencies that would further the appropriate enforcement of the state's tax laws and also generate additional net revenues for the state?

2. In this regard, what programs or efforts have been developed by the agencies and in what stage are these efforts?

3. What would the long-term impact of DOF's interpretation of its directive be on the state's tax administration and revenue collection?

Department of Finance

1. Is DOF open to a reinterpretation of its own rules in how they are applied to revenue generating agencies?

Legislative Analyst's Office

1. What would be the long-term impact of the current approach by DOF on tax gap efforts?

Staff Recommendation: No recommendation at this time, pending additional staff review.

Vote: NA

0860 Board of Equalization

Department Overview: The State Board of Equalization (BOE) is comprised of five members—four members each elected to the board on a district basis, and the State Controller. The BOE administers the sales and use tax (including all state and local components), oversees the local administration of the property tax, and collects a variety of excise and special taxes (including the gasoline tax, insurance tax, and cigarette and tobacco products taxes) and various fees (including the underground storage tank fee, e-waste recycling fee, and fire prevention fee). The BOE establishes the values of state-assessed property, including inter-county pipelines, railroads, and regulated telephone, electricity, and gas utilities. The BOE also hears taxpayer appeals of BOE-administered taxes and fees and FTB decisions on personal income and corporation taxes.

Budget Summary: The Governor's budget proposes resource support of $577.9 million ($323.6 million General Fund), and 4,830 positions for the BOE in fiscal year 2015-16. The budget proposes a total funding decrease of $4.3 million (0.7 percent) and a very slight General Fund support decrease, compared with spending estimates for the current year. Proposed staffing in the budget would increase by just 18.3 positions from the current-year estimate. The department received much higher increases in funding during the current year, compared to 2013-14.

Issue for Discussion:

Issue 1: Centralized Revenue Opportunity System (Oversight)

Background: BOE is in the process of consolidating and modernizing its existing taxpayer information systems through the Centralized Revenue Opportunity System (CROS) project. As designed, CROS would replace the BOE's two existing systems of tax information and return management, expand online business and taxpayer services, and provide an agency-wide data warehouse. CROS would replace two legacy systems—Integrated Revenue Information System (IRIS) and Automated Compliance Management System (ACMS).

The acquisition of CROS will be achieved through a performance-based, benefits-funded procurement approach. This approach is similar to that used by the Franchise Tax Board (FTB) and the Employment Development Department (EDD) for their respective information and data management systems. The approach does not require up-front vendor funding, as the development and implementation costs are paid under a benefits-funded contract, with payment allowed only when increased revenues are received. Contractor payments would be dependent on the generation of additional revenues attributable to the project and would be capped overall.

The agency indicates in its most recent annual report to the Legislature (December 1, 2014), that it is conducting pre-implementation activities to mitigate risks that typically undermine large-scale IT projects, comprising: program area readiness, data readiness, external interfaces, and business intelligence analytics. The agency indicates that the project procurement phase was delayed eight months due to the following:

- The Department of Technology (CalTech) administered a detailed technical review of proposed revenue-generating strategies to assess possible impacts with BOE policy (four-month delay).

- Vendors expressed concerns regarding financial requirements for functional, technical, and project management deliverables expected during the implementation phase (three-month delay).

- BOE reviewed and streamlined requirements for functional, technical, and project management deliverables expected during the implementation phase (one-month delay).

The Special Project Report #2, approved by CalTech in February 2014, limits costs for planning, Request for Proposals development, and procurement to $25.2 million. This is expected to last to September 2015. The procurement contract is expected was to be awarded in October 2015. The project was given $30.1 million in budget authority in 2012-13, and incurred $25.0 million in costs. The BOE reports additional revenue (due to early implementation activities) of $38.7 million (data cleansing) in 2012-13, $70.4 million (enhanced tools and consulting services) in 2013-14 and an estimated $66.5 million (increased positions) in 2014-15.

The budget year is a key year for the implementation of the project. BOE provided the following next steps and timeline in its December report:

• Submission of Final Proposals	February 26, 2015
• Notification of Award	August 19, 2015
• Contract award and Execution	October 21, 2015
• Project Start Date	October 22, 2015
• Maximum Project End Date	October 26, 2020

In March 2015 discussions with staff the agency indicated that the timeline has slipped roughly three months further, specifically the new timeline is: Submission of Final Proposals—May 11, 2015; Notification of Award—October 21, 2015; Contract Award and Execution—January 4, 2016; Project Start Date—January 5, 2016; and Maximum Project End Date—January 4, 2021.

Staff Comments: In the roughly three and one-half months since the agency issued its report to the Legislature, there have been additional delays. According to the agency, the contract award and project start date is now slated for January 2016. Complications with the financing model for the project—benefits based—were identified as one of the primary reasons for the additional delay. Clearly, it’s better to experience delays and ‘get it right’ than to accelerate a project that isn’t ready. Nevertheless, the frequent delays at least raise the question of the overall ability of the agency (and its partners) to manage a project of this scope. Fortunately, we are still in the procurement phase of the project, rather than implementation when delays would result in direct costs. While CROS is being prepared for implementation, BOE must maintain its legacy systems. As part of this, the agency will submit a Spring Finance Letter to provide for the implementation of AB 1717 (Perea), Chapter 885, Statutes of 2014, which established the Mobile Telephone Surcharge and assigned the administrative activities associated with the fee to BOE. Given this, staff recommends holding the agency's budget open, pending consideration of this as well as other issues.

Questions:

Board of Equalization

1. Would CROS have been able to prevent the misallocation of sales tax revenue from local governments to the General Fund that was uncovered last year?

2. How many and what changes in the timing of the implementation of CROS has occurred since it was first approved by the Administration?

3. When will revenues from the project first begin to occur?

4. In 2013-14, the BOE board approved a BCP designed to reduce the accounts receivable backlog, which was rejected by DOF on the basis that CROS would address this. Since as accounts receivable age, they become increasingly difficult to collect, and given the delays associated with CROS, what has been the revenue impact of not implementing this initiative? (Note: For 2015-16, the proposal would have had costs of $23.9 million and generated revenues of close to $100 million.)

California Department of Technology

1. Please provide you assessment of the status and the immediate prospects for the CROS project.

Staff Recommendation: Informational and oversight item.

7730 Franchise Tax Board

Department Overview: The Franchise Tax Board (FTB) is one of the state's two major tax collection agencies and administers the personal income tax and the corporation tax programs, the largest and third-largest contributors to the state's revenue, respectively. The department also performs some non-tax collection activities, such as the collection of court-ordered payments, delinquent vehicle license fees, and political reform audits. 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, manages the daily functions of the department.

Budget Overview: The Governor's budget proposes expenditures of $698.9 million ($666.8 million General Fund) and 5,885 positions for FTB. This represents a continuation of a substantial increase in support for the agency, compared to the 2009-10 fiscal year, but somewhat of a decrease from the current year funding level of $729.8 million. Expenditures grew from $533.1 million in 2009-10 due primarily to reinstating some of the budget reductions from earlier years as well as new programs. The budget reinstatements were made to reverse negative revenue impacts of the prior Administration's statewide cuts and furloughs, which included the state's tax collection agencies. In addition, the budget calls for augmentations for specific tax compliance programs and technology improvements related to the department's revenue collection activities. Recent budget increases have also been the result of funding for the Enterprise Date to Revenue (EDR) project, a benefits-funded project discussed below.

Issues for Discussion / Vote:

Issue 1: Mainframe Workload Growth (BCP 1)

Background: The FTB is responsible for maintaining the mainframe environment so the Enterprise Data to Revenue (EDR) system, discussed below, can be implemented. In addition, the mainframe is essential for the department's legacy applications, including taxpayer information (TI), business entity tax system (BETS), and court-ordered debt (COD). In addition, the mainframe applications operates in conjunction with the accounts receivable collections system (ARCS), the professional audit support systems (PASS), integrated non-filer system (INC), and online self-service applications for taxpayers.

Typically, FTB has replaced the mainframe every four years, with the most recent replacement in 2011-12. In addition, the FTB upgrades the mainframe CPU every two years to increase the millions of instructions per second (MIPS). In the past, FTB experienced a ten percent annual growth rate in MIPS demand, but in 2013-14 the growth rate was 47 percent. In addition, there have been instances of MIPS demand spikes due to software upgrades, increased workloads, and testing demands. These factors combined have contributed to increased CPU usage beyond the original historical based ten percent annual growth projections. FTB has since determined that the annual growth in demand for MIPS is likely to be in the range of 12 to 15 percent.

Governor's Proposal: The FTB requests an augmentation of $8.6 million General Fund and $354,000 in special funds in 2015-16, and $1.8 million General Fund and $73,000 in special funds in 2016-17, for replacement of the mainframe's central processing unit, additional memory, storage space, and software to meet near-term workload growth projections. These additions and expansions will allow for the continued implementation of the EDR project as well as allow the department's legacy systems to maintain sufficient processing capacity to process and collect current revenues.

Staff Comments: Staff has no concerns with this budget request.

Staff Recommendation: Approve as budgeted.

Vote:

Issue 2: Enterprise Data to Revenue Project—Information Technology (BCP 2)

Background: The FTB processes more than 15 million personal income tax returns and one million business enterprise returns annually. Its operations are heavily reliant on effective storage and use of data from a variety of sources. The continuation of the EDR project is expected to fund the technology-intensive portion of the project. FTB indicates that the initial revenues generated by the EDR project were primarily from adding staff to process the current backlog of business entity returns and begin collection correspondence in order to accelerate revenue. Beginning in 2011-12, substantial revenues were generated by the EDR project proper.

The EDR project has three major goals. First, it seeks to capture all tax return data in an electronic form. Second, the project will integrate the various existing "siloed" tax databases at FTB into a data warehouse. Third, the project will enable FTB to add third-party data (for example, county assessor data) to its data warehouse. The FTB asserts that the EDR Project will allow it to substantially improve detection of underpayment and fraud in order to collect taxes from those who are not paying the full amount that they owe. In addition, FTB indicates that the project will enable it to improve service and give taxpayers better access to their tax records.

The project includes the following improvements to FTB's systems that process personal income tax and business entity tax returns:

- An underpayment modeling process that would be integrated with the Accounts Receivable Collections System and Taxpayer Information System.
- An enterprise data warehouse with data search and analysis tools.
- A taxpayer records folder that is accessible to the taxpayer and allows taxpayers and FTB staff to access the information.

- Re–engineering of existing business processes—including imaging of tax returns, data capture, fraud and underpayment detection, tax return validation, filing enforcement, and other audit processes—and integration of these enhanced business processes with FTB's existing tax systems.

- Improved business services at FTB, such as address verification, issuance of notices, and a single internal password sign-on for its IT systems.

Contractor payment for system development and implementation are conditioned on generating additional revenue that will more than cover the cost. This approach is intended to protect the state and also give the contractors a strong incentive to develop the project in a manner that produces significant revenue quickly. The FTB has used this approach previously. FTB's benefit-funded approach made use of revenue gains from reducing the business entity backlog to more than offset costs in 2009-10 through 2012-13. Cleaning up the backlog was a necessary condition to efficient project development. In subsequent years, there have been large increases in annual revenue gains that are directly attributable to the IT project. For 2010-11 through 2013-14, revenue projections were $444 million, but actual revenue generated was $863 million. FTB expects that the projected $4.7 billion of additional revenue through the life of the project (terminating in 2017-18) will be realized. The benefits method of financing EDR is similar to that used by the Employment Development Department (EDD).

Governor's Proposal: The budget proposes $44.7 million and 20 three-year, limited-term positions in 2015-16 to continue the implementation of EDR project. Of the total budgeted amount, $41.2 million constitutes the vendor payment with the remainder slated for personnel costs and to pay for project oversight by the California Department of Technology (CalTech). The budget year is the fifth year of the project, and to date, FTB reports that the project is on schedule, within scope, and within budgeted project costs. The budget proposal includes a placeholder for the project's 2016-17 requirements, which includes $53.6 million for maintenance and operations (with $39.9 million earmarked for vendor payments). As indicated above, the vendor payment is directly tied to revenues generated. Revenues generated by the project for 2015-16 are expected to be between $760.5 million and $1.1 billion. The 20 limited-term positions will support the ongoing current IT work associated with the project. The positions will also facilitate and address knowledge management, transition of the system, and training. The efforts are designed to prepare FTB staff to take over maintenance and operations of EDR by January 1, 2017,

Staff Comments: The net benefit of this project ramps up quickly. As noted above, the project began to produce significant net revenues starting in 2011-12. The FTB has among the best track records in California state government for the successful development and implementation of major information technology projects. FTB projects have experienced some delays and cost increases in certain phases, although these problems generally have not prevented successful timely completion of overall project phases. The committee may ask the LAO and CalTech to comment on the project. The department has provided strong management of the implementation of EDR, to date. Nevertheless, given the sensitive nature of the project, and its direct relevance to revenue collection for the state, the committee is wise to provide continual annual oversight of the project. The department expects to submit an additional request to the Legislature in a Spring Finance Letter.

Questions:

Franchise Tax Board

1. When will FTB take over the operation of the system? Given the advance training and knowledge transfer, could additional reductions be made in the vendor payments if FTB staff can accelerate the displacement of vendor resources?

2. It does not appear from the documentation that there have been many change order requests, which can often drive excessive IT costs. What has been the department's approach in largely avoiding these?

California Department of Technology or Department of Finance

1. Could you provide for the submitted your assessment of the status of the project? Is the project on track for completion at the specified date?

2. What particular features of the EDR project are easily implemented in other venues?

Staff Recommendation: Hold open.

Vote:

Issue 3: Enterprise Data to Revenue Project—Program (BCP 3)

Background: General information about the EDR project is provided in the item above. The components in this proposal—Fraud Unit and Authenticated Live Chat—are being incorporated into the design of the project. The Fraud Unit detects and prevents fraud related to refundable credits, identity theft, and preparer-driven issues related to unwarranted deductions and credits. FTB implemented fraud detection rules as part of the return validation process over ten years ago. Such deduction and prevention of fraud is expected to improve by incorporating these activities into the EDR project. Authenticated Live Chat is the next step up from Live Chat. Under Authenticated Live Chat, security is such that confidential taxpayer information may be exchanged, and personal tax situations addressed. The current Live Chat protocol allows for only general tax information to be addressed, without the exchange of information regarding personal tax situation.

Governor's Proposal: The budget proposes $2.5 million and 33 positions (25 permanent and eight two-year, limited-term) to support the Fraud Unit and Authenticated Live Chat associated with the EDR. The EDR project includes enhanced fraud modeling tools that will allow the FTB to better detect fraudulent activity and stop an additional $40 million in refund and identity theft fraud returns from being issued to fraud perpetrators. The 25 permanent positions will be assigned to this unit. The proposal includes the provision of resources to Authenticated Live Chat, which will permit the exchange of personal tax information, and is expected to be implemented by July 1, 2015. The eight limited-term positions will be assigned to this activity. The proposal also calls for budget bill language which would allow the Department of Finance (DOF) to augment the department's budget by up to $3.5 million, upon 30 days notice to the Joint Legislative Budget Committee, to provide additional resources to the EDR project for tax data preparation and capture of information from personal income tax and corporation tax documentation.

Staff Comments: Staff has no fundamental concerns with the proposal, but recommends the item be held open pending receipt of an expected Spring Finance Letter. The proposed budget bill language is similar to that which the Legislature approved last year.

Questions:

Franchise Tax Board

1. Given the increase in personnel for the Fraud Unit, does it make sense to make some of these positions limited-term—especially as EDR comes on line and makes the process more efficient? What training is involved in the positions, and do we risk not attracting good personnel if they are made limited-term?

Staff Recommendation: Hold open.

Vote:

Issue 4: Top 500 Income Tax Delinquencies (BCP 4)

Background: As part of its efforts to reduce the tax gap, the Legislature approved AB 1424 (Perea), Statutes of 2011, Chapter 455, that expanded the list of designated delinquent taxpayers from 250 to 500, required updating the delinquent taxpayer list, and provided certain tax collection tools used to collect tax debt. To implement this legislation, the 2012-13 budget included funding for seven three-year, limited-term positions. These positions expire at the end of the current year. The revenue generated by the program was $64.9 million in 2012-13 and $74.1 million in 2013-14, and is expected to be $70.0 in 2014-15. The positions are responsible for the following activities: publishing the top 500 debtor lists at least twice per year; suspending occupational, professional, and driver licenses held by debtors appearing on the top 500 debtors list; administering the reinstatement of licenses of taxpayers who come into compliance; and, prohibiting state agencies from contracting for goods or services with a tax debtor on the list. The program involves the following actions regarding noncompliant taxpayers: 1) an initial letter indicating that placement on the top debtor's list will occur; 2) a secondary letter indicating such placement is imminent; and 3) placement of the taxpayer's name on the top debtors list. Most of the revenue generated by the program is attributable to the two letters, indicating that the prospect of public opprobrium is more effective than the actual publicity engendered by placement on the list.

Proposal: The department's proposal would make permanent six positions for the administration of the top debtors program. FTB indicates that the work associated with the tax compliance program is ongoing in nature and the resources are critical to the continued effectiveness of the efforts.

Staff Comments: Staff recommends approval of the request from the department. The program has been challenged in court—in particular, the license suspension aspect—but the decisions have been mixed. A least two cases are on appeal. Given the success of the program, it would seem wise to continue its funding.

Staff also notes the apparent inconsistent application of BL 14-12. This BCP, which is a program designed to address the tax gap—based on DOF's current interpretation—does not appear to meet any of the circumstantial tests noted in the BL 14-12 DOF directive. One could argue that this BCP request is an exception, since it results in the conversion of existing limited-term positions to permanent; however, this is not a qualified exception under the circumstances provided in BL 14-12.

Questions:

Franchise Tax Board

1. With a recent decision against the FTB action to rescind a state license, do you see this as affecting the efficacy of the program?

Staff Recommendation: Approve as budgeted.

Vote:

Issue 5: Collection of Delinquent Accounts (Trailer Bill Language)

Background: The FTB is responsible for collecting certain delinquencies related to vehicles including registration fees, transfer fees, and parking violation penalties.

Governor's Proposal: The proposed trailer bill language would expand the types of vehicle-related charges that are collected by the FTB to include unpaid tolls, toll evasion penalties, or any related administrative or service fees.

Staff Comments: Staff has no concerns with this proposal.

Staff Recommendation: Approve placeholder trailer bill language.

Vote:

Item for Discussion

Oversight—State Debt and Financial Management

Presentation: **State Treasurer's Office**
Department of Finance

Comments: **Legislative Analyst's Office**

BACKGROUND

Long-Term Debt. The state uses general obligation bonds (GO bonds) to borrow funds for spending—primarily for infrastructure and other capital investments. The use of bonds to accelerate capital projects is a commonly-used practice of government entities. Bonds must be approved by voters and bond proceeds are either continuously appropriated (immediately available for expenditure) or require an appropriation from the Legislature. All bond debt service is continuously appropriated and, therefore, not appropriated in the annual budget bill. The state has $79.0 billion in outstanding GO bond debt (including self-liquidating bonds such as the Economic Recovery Bonds [ERBs]). Another $31.7 billion in bonds are authorized, but remain unissued. In most instances, bonds are sold at different lengths of maturity such that repayment is spread over about 30 years. The chart below indicates the authorized, but unissued, reservoir of bonds.

General Obligation Bonds Authorized and Not Issued
(Dollars in Millions)

Authorized Bond Program	Unissued Amount
Prop 1A of 2008: High-Speed Rail	$9,003
Prop 1 of 2014: Water Quality, Supply, and Infrastructure	7,545
Prop 1B of 2006: Transportation	4,585
Prop 84 of 2006: Safe Drinking Water	2,826
Prop 1E of 2006: Disaster Prep and Flood Prevention	1,719
Prop 71 of 2004: Stem Cell Research	1,340
Prop 46 of 2002 & Prop 1C of 2006: Housing	1,201
Prop 55 of 2004 & Prop 1D of 2006: Education Facilities	803
All other	2,684
Total	**$31,706**

The state generally goes to market to sell GO bonds twice annually—once in the spring and once in the fall. Bond structures are often tailored to meet market demand and investor appetite. This tailoring includes tinkering with variables such as fixed and variable rates, call features and premiums, and various security enhancements. Bonds are sold in amounts necessary to meet expenditure needs, plus an additional cash cushion to account for flexibility regarding how fast projects will expend funds and uncertainty about the timing of the next bond sale.

Debt Service. Expenditure of bond proceeds is reflected in the budgets of individual departments, with the payment of bond debt service consolidated in Item 9600 in the Governor's budget. It is the repayment of bond debt that is reflected as a General Fund expense. Some bond costs are offset by special funds or federal funds. Other bonds are 'self-liquidating,' or have their own dedicated revenue. For example, the ERBs receive a quarter-cent of the sales tax as a component of the 'triple flip' enacted as part of the 2004 budget package. Once the ERBs are paid off, largely in the current year, as proposed in the Governor's budget, sales tax resources dedicated to General Fund bond repayment would be freed up.

The Governor's budget includes $5.4 billion in General Fund costs for GO bond debt service and related costs. (As mentioned earlier, most of the remaining cost of the ERBs is expected to be paid in 2014-15 by making a payment of $3.9 billion. There may be a much smaller payment of $132 million in early 2015-16 to pay off the loans.) In addition, $1.2 billion in debt costs are scheduled to be funded from special funds. Finally, federal bond subsidies, through the Build America Bonds (BABs) program, will provide $326 million in 2015-16, allowing for a reduction in General Fund expenses. The Governor's proposed budget includes $114.6 billion in General Fund for debt service (not including carry-over balances and the transfer to the rainy day fund), so the net General Fund bond debt service as a percentage of General Fund resources is about 5.0 percent.

Governor's Budget for General Obligation Bond Debt
(Dollars in Millions)

Category	2013-14 Actual Cost	2014-15 Estimated Cost	2015-16 Forecasted Cost
General Fund Cost	$4,798	$5,091	$5,377
Other Funds Cost	1,050	1,076	1,195
Federal Subsidy (Build America Bond Program)	326	326	326
Total Debt Service	**$6,174**	**$6,493**	**$6,898**
Economic Recovery Bonds (ERBs, not included above because indirect GF cost)	$1,538	$3,931	$132

The budget plan includes an assumption that $2.0 billion in GO bonds will be sold in the spring of 2015, and that $1.6 billion more will be sold in the fall of 2015. Among these planned sales are $1.8 billion for transportation and related capital facilities, $800 million for various natural resources bonds, $421 million related to housing bonds, and $346 million for various education facility bonds.

Bond Management. As the state's cash situation deteriorated with the most recent recession, the Administration changed the methodology for managing bond cash. Prior to the recession, reserve cash funded project costs in advance of bond sales, and then bond sales replenished cash reserves. When reserve cash declined, the state had to instead sell bonds in advance of expenditures. Due to project expenditures occurring slower than anticipated at the time of bond sales, large bond cash balances developed—about $9.7

billion as of December 2011. As a result, the Administration implemented a plan to utilize commercial paper to aid cash flow, and reduce the need to carry large bond cash balances. The Administration also requires GO bond programs to demonstrate an immediate need for additional bond proceeds prior to issuing new bonds. Progress has been made to reduce bond cash, which is shown in the table below.

General Obligation Bonds Current Cash Proceeds
(Dollars in Millions)

Authorized Bond Program	Bond Proceed Cash Remaining*
Prop 1B of 2006: Transportation	$1,536
Prop 1E of 2006: Disaster Prep and Flood Prevention	569
Prop 50 of 2002: Water Security	314
Prop 1A of 2008: High Speed Rail	265
Prop 1D of 2006: Public Education Facilities	227
Prop 13 of 2000: Safe Drinking Water	197
Prop 84 of 2006: Safe Drinking Water	195
Prop 1C of 2006: Housing	184
Prop 71 of 2004: Stem Cell Research and Cures Bond	120
All others	416
Total	**$4,023**

* As of November 2014,

Staff Comments: Most state capital investments are intended to provide benefits over many years, and it is reasonable and appropriate that current and future taxpayers and beneficiaries provide the funding. Bonding for such projects is often the most feasible option, as well as the preferred option. Pay-as-you-go financing is also appropriate to the extent that payments show correspondence with the use and depletion of the public capital. However, bonds allow the public to enjoy the benefits of infrastructure investment more quickly than would otherwise be the case. Given the volume of the state's infrastructure needs and other competing priorities (including debt service on existing bonds), it is likely that bonds will continue to play a major role in infrastructure funding well into the future. These could be either general obligation bonds or bonds financed by user fees depending upon the distribution of benefits and the feasibility of collecting user charges.

California has steadily increased its reliance on debt to fund capital projects, resulting in debt-service-related cost pressures to the state's General Fund. The extent in which the state undertakes additional borrowing will affect the state's debt-service ratio—the portion of the state's annual General Fund revenues required for debt-service payments. The debt-service ratio has changed over time, peaking at about six percent in 2009-10 and 2010-11, according to LAO. If currently authorized bonds are issued, the debt-service ratio could reach close to these levels again in 2015-16. LAO notes that while there is no 'correct' debt-service ratio, elevated levels do restrict the ability to pay for other programs. Thus, the debt-service ratio provides an indication of the relative priority of debt service and infrastructure compared to other General Fund spending, with higher ratios associated with prioritization of infrastructure spending. Because debt payments are generally fixed and cannot be easily reduced by restructuring, they are significantly less flexible than other types of expenditures.

Voters approved over $40 billion in new bonds on the 2006 ballot, just prior to the national recession. During difficult budget times, such as the recent great recession, bonds enable the state to invest in infrastructure while the need for economic stimulus is most acute, borrowing costs are low, and construction procurement is favorable. Despite the benefits of bonds, they come with the cost of many years of debt service. Assuming that a bond carries an interest rate of five percent, the cost of paying it off with level payments over 30 years is close to $2 for each dollar borrowed—$1 for repaying the amount borrowed and close to $1 for interest. This cost, however, spread over a 30-year period, after adjusting for inflation is considerably less—about $1.30 for each $1 borrowed. That bond cost crowds out alternative expenditures over the life of the bond. The Legislature can prioritize or limit bond funding through the budget process as overall expenditures are prioritized. This question may be particularly acute as interest costs climb as a result of increased demand for capital as the economy continues to recover.

Questions:

State Treasurer's Office and Department of Finance:

1. Given the Governor's indicated concern about deferred maintenance, how would additional infrastructure investment be incorporated into the state overall debt service schedule?

2. How does the state maximize the cost advantages of a low interest rate environment? Are there additional steps the state could take to minimize these costs?

3. Describe the current approach for management of bond proceeds, forecasts of project expenditures, and the optimal level of cash balances.

Items for Discussion / Vote

9620 Cash Management and Budgetary Loans

Program Summary: This budget item appropriates funds to pay interest costs on General Fund borrowing used to overcome cash flow imbalances during the fiscal year. Because receipts and disbursements occur unevenly throughout the fiscal year, the General Fund borrows in most years, even though each budget is balanced when enacted, and funds are repaid within the fiscal year. This item additionally pays interest costs for budgetary borrowing by the General Fund from special funds. Budgetary borrowing is across fiscal years and is scored as a budget solution, whereas cashflow borrowing is not counted as a budget solution, but conducted in order to maintain adequate cash reserves.

Budget Overview: This item appropriates funds for interest costs associated with cashflow and budgetary borrowing. The budget includes $20.0 million General Fund for the interest costs associated with internal borrowing costs. The proposed amounts are conservative and based on budgeting sufficient funds to cover the uncertainty in interest rates and other factors. In addition, the budget includes $26.8 million in interest costs associated with the repayment of internal budgetary borrowing from special funds.

Issues for Discussion / Vote:

Issue 1: Cashflow Borrowing (Governor's Budget Proposal)

Background: The state can access both internal and external cashflow borrowing. Generally, internal sources are assessed first, and external borrowing is used to supplement internal sources. This provides an additional cashflow cushion to the existing availability of internal resources. Without the external borrowing, there would typically be insufficient cash reserves and other funds during the months of October, November, December, and March. Maintaining an adequate cash balance by using both internal and external borrowing allows the state to pay its bills in a timely fashion. Interest is paid on internal borrowing (such as cash flow loans from special funds) and external borrowing through the issuance of Revenue Anticipation Notes (RANs). For the current year, the state issued a RAN in September of 2014 of $2.8 billion. The RAN is payable in June 2015 and carries an expected interest cost of $20 million.

Total monthly borrowable internal resources from some 700 plus funds are typically in the range of $20 billion. The state also established an additional cash flow tool in the form of the Voluntary Investment Program (VIP) in 2012. This measure provided an additional means to assure cash flow continuity by establishing a new account for voluntary participation by local governments. Another cash management tool of the state is the State Agency Investment Fund (SAIF), which attracts deposits from entities not otherwise required to deposit funds with the state. The VIP and SAIF were not used in the current year.

An additional tool in managing cash is deferrals of payments within the fiscal year to K-12 and higher education, local governments, and other entities. In recent years, flexible deferrals have been enacted in statutes that allow specified deferrals, if necessary to maintain a prudent balance for bond debt and other priority payments. The 2014-15 budget included a statutory provision providing that any increases in the Proposition 98 minimum guarantee first be used to pay down late payments to schools and community colleges. For the current year, there were deferrals allowed for K-12 education, higher education, and local government payments. The fiscal impact of these deferrals varies from entity to entity, depending upon their own cash positions.

Governor's Proposal: The Governor's budget does not anticipate engaging in external RAN borrowing in 2015-16 and assumes that internal borrowing will be adequate to cover the low points in the state's cash position. The budget reflects the state's improved cash position and, if projections hold, would be only the second year since the mid-1980 that the state has not issued a RAN. Given the improvement in the cash status, no new education or other payment deferrals are incorporated in the budget. Based on the cash flow statements of the Administration, the cash low points will occur in December, and March, when unused borrowable cash resources are estimated to be $9.5 billion and $8.9 billion, respectively. By way of comparison, and reflective of the uneven flow of receipts and disbursements, the cash and borrowable resources in June of the budget year are estimated to be $24.2 billion.

The state anticipates engaging in its typical internal cash borrowing, with all internal cash flow borrowing managed such that the programs supported by these special funds are completely unaffected. The budget includes $20 million for internal borrowing costs. As mentioned earlier, the Administration has not proposed a RAN. However, the budget includes $20 million for RAN costs, which the Legislature can delete if the state does not need to borrow externally. There is no anticipated need for the VIP or the SAIF in the Governor's budget.

Consistent with law enacted as part of the 2014-15 budget, the Governor's budget proposal includes $992 million to eliminate all remaining school and community colleges deferrals. In addition, the Administration has not incorporated any new deferrals as part of the budget plan. However, there is the continuation of a $500 million within-the-year deferral to UC and a deferral of up to $250 million of CSU's annual General Fund appropriation. In addition, the Governor's budget assumes the continuation of smoothing of payments to UC and CSU that have been carried out in recent years. The continuation of this policy, proposed for budget bill language, would smooth payments over ten months with the remaining amount owed remitted in the final two months of the year.

Staff Comments: Maintaining an emphasis on cashflow borrowing from internal sources is sound fiscal policy that reduces the need for more expensive external borrowing. The LAO finds that some of the estimated borrowing costs may be too high based on past costs. At the time of the May Revision, the Administration's proposal will likely be updated and at that time should be reassessed to ensure that the estimated borrowing costs are appropriate. The LAO also notes that unlike most items in the annual budget plan, Item 9620 interest costs will automatically be paid if interest costs prove to be higher than budgeted. Both Items 9620-001-0001 and 9620-002-0001 include provisional language appropriating "any amount necessary" to pay required internal borrowing and budgetary loan interest costs.

Questions:

Department of Finance

1) Could you explain the basis for the estimated internal cashflow borrowing costs of $20 million for 2015-16?

2) How does the department assesses the potential of any impact on the lending program of cash flow borrowing by the General Fund?

Staff Recommendation: Hold open and reassess at the May Revision.

Issue 2: Budgetary Borrowing Payment Plan (Governor's Budget Proposal)

Background: Through budget actions over the last decade, the state has borrowed from special funds and deferred various payments to schools in order to help balance the state budget. By the close of 2010-11, DOF indicates that a total of $34.7 billion in loans and deferrals had accumulated and remained unpaid. This amount largely represents the debt overhang from prior year budgets adopted under the previous Administration and is referred to as the "wall of debt." By the beginning of 2015-16, this amount is expected to be reduced to $12.9 billion.

Some obligations included in the "wall of debt" have required repayment in specified years due to constitutional requirements or due to scheduled bond debt service. Other debt payments are more flexible and can be repaid over time as the budget situation allows, such as school payment deferrals, and as long as borrowing does not interfere with the activities that a special fund loan supports. The General Fund is typically used to pay off budgetary debt.

In addition to the "wall of debt," the state has accumulated liabilities for retirement costs for state employees, teachers, judges, and University of California employees. These liabilities total $221.6 billion at the start of 2015-16. Some of these unfunded liabilities are being addressed with routine annual payments over time.

Proposition 2, passed by the voters in November 2014, changes the way the state pays down debt and liabilities and saves money in reserves. According to the LAO, Proposition 2 could result in roughly $15 to $20 billion being used to pay down certain state debts. Choices about how calculations are made under Proposition 2 determine the amount of funds that will be split evenly between the Budget Stabilization Account (BSA) or paying down debt.

Governor's Proposal: Under the Administration's calculations, Proposition 2 captures a total of $2.4 billion in revenue in the budget year. Proposition 2 requires that this amount be split evenly between paying down existing state debt and deposits to the BSA. As shown in the figure below, the Governor proposes to spend the required $1.2 billion on paying down $965 million in special fund loans and $256 million in prior-year Proposition

98 costs known as "settle-up". In addition, the Governor's multi-year budget plan proposes to fully repay special fund loans and settle-up costs by the end of 2018-19.

Governor's Proposal for Debt and Liabilities Payment
(Dollars in Millions)

Debt and Liabilities	Amount Beginning 2015-16	Proposition 2 Eligible	Payment in 2015-16
Budgetary Debt			
Loans from special funds	$3,028	Yes	$965
Underfunding Prop 98- settle up	1,512	Yes	256
Unpaid mandate claims for local governments	257	Yes	-
Deferred payments to CalPERS	530	Yes	-
Unpaid costs to schools and community colleges for state mandates	4,219	No	196
Prop 98 Williams settlement	273	No	273
Deferred Medi-Cal costs	2,227	No	-
Deferral of state payroll costs from June to July	783	No	-
Borrowing from Transportation Funds (Prop 42)	84	No	84
Subtotal	**12,913**		**1,774**
Liabilities			
State retiree health	71,773	Yes	-
State employee pensions	49,978	Yes	-
Teacher pensions	74,374	Yes	-
Judges' pensions	3,371	Yes	-
University of California (UC) employee pensions	7,633	Yes	-
UC retiree health	14,519	Yes	-
Subtotal	**221,648**		**-**
Total	**$234,561**		**$1,774**

The special fund loans (as noted in the first line from the table above) that would be repaid under the Governor's proposal are shown in the following table.

Governor's Proposal for Repayment of Special Fund Loans (Dollars in Millions)

Fund Name	Amount
Unemployment Compensation Disability Fund	$303.5
Motor Vehicle Account	300.0
State Courts Facility Construction Fund	220.0
Electronic Waste Recovery & Recycling Account	27.0
Vehicle Inspection Repair Fund	25.0
Hazardous Waste Control Account	13.0
California Health Data and Planning Fund	12.0
Off–Highway Vehicle Trust Fund	11.0
Contingent Fund of the Medical Board of California	10.0
Enhanced Fleet Modernization Subaccount	10.0
Board of Registered Nursing Fund, Professions and Vocations Fund	8.3
Dealers' Record of Sale Special Account	6.5
Accountancy Fund	6.0
Private Security Services Fund	4.0
Debt and Investment Advisory Commission Fund	2.0
Debt Limit Allocation Committee Fund	2.0
Physical Therapy Fund	1.5
Behavioral Science Fund	1.2
Illegal Drug Lab Cleanup Account	1.0
Speech-Language Pathology and Audiology Fund	0.5
Driving-Under-The-Influence Program Licensing Trust Fund	0.4
Total	**$964.8**

Staff Comments: The Governor has prioritized using Proposition 2 funds to pay off special fund loans and prior-year Proposition 98 settle up obligations. However, alternative uses of these funds could pay down certain liabilities faster or potentially free up General Fund dollars for other purposes. For example, the Governor, in his budget, highlighted the $72 billion unfunded liability for retiree health care costs and described a plan largely reliant upon employee bargaining to eliminate the liability in about 30 years. The Administration could have used a portion of the Proposition 2 funds to pay down some of the retiree health care unfunded liability. Alternatively, Proposition 2 funds could be used to pay off liabilities that the Governor proposes to pay off using General Fund dollars, such as some of the California State Teachers Retirement System (CalSTRS) liability or potentially transportation fund borrowing. In addition, the state could pay off more or less special fund loans now than the Governor proposes. Some of the loan repayments proposed are necessary, some of the loans could be repaid to help meet the desired program objectives, and some repayments are unnecessary to make at this time, as the programs have been operating for many years without the funds.

Questions:

Department of Finance

1) What is the basis for the estimated borrowing cost of $26.8 million for the budgetary borrowing?

2) Describe the metrics that were used in the determination of the Proposition 2 debt reduction and the selection of budgetary borrowing to be repaid of the $3.0 billion outstanding.

Legislative Analyst's Office

1) Can you discuss various alternatives in terms of what can be included or not included in the Proposition 2 debt pay-down?

Staff Recommendation: Hold open and reassess at the May Revision.

0950 State Treasurer's Office

Department Overview: The State Treasurer's Office (STO), a constitutionally established office, provides banking services for state government, with goals to minimize interest and service costs, and maximize yields on investments while minimizing risk. The STO is responsible for the custody of all moneys and securities belonging to or held in trust by the state; investment of temporarily idle state moneys; administration of the sale of state bonds, their redemption and interest payments; and, payments of warrants or checks drawn by the State Controller's Office (SCO) or other state agencies. The STO includes the following programs: Investment Services; Centralized Treasury and Securities Management; Public Finance; and Administration and Information Services. The Treasurer chairs 14 boards and commissions related to state finance.

Budget Summary: The proposed budget for the STO calls for 232.4 positions and $29.7 million in funding ($4.8 million General Fund). The STO is funded largely through reimbursements from other funds. The budget represents a slight reduction and positions from the current year budget.

Issues for Discussion / Vote:

Issue 1: Debt Management System (Informational)

Background: The State Treasurer's Office has embarked on a new debt management system and received amounts in both 2013-14 and 2014-15 to fund this project. As part of last year's budget, the department received authority for $1.1 million in bond funds. The amounts have included funding for a procurement consultant and related vendor, oversight costs of California Technology Agency, and permanent positions. The system is necessary for debt administration, including duties associated with trustee, registrar and paying agent responsibilities, payment of debt service, disclosure and analysis of debt issuances. Given the increased legal and financial complexities in the debt markets, the STO indicates a need for a new system to administer outstanding debt, track and pay debt service and fees on outstanding debt, and track and validate the issuance of new debt. The existing system dates to 2004.

Governor's Proposal: There was no proposal submitted to the Legislature as part of the Governor's budget; however, the STO expects that a Spring Letter may be submitted.

Staff Comments: The project is a relatively limited project in terms of overall costs, nevertheless, given the state's recent track record on information technology procurement and projects, ongoing legislative oversight continues to be an important component to help ensure the best outcome possible.

Staff Recommendation: Informational issue.

Issue 2: Health Facilities Construction Financing (Trailer Bill Language)

Background: The California Health Facility Construction Loan Insurance Program is administered by the Office of Statewide Health Planning and Development and insures loans taken out by operators of nonprofit and public health-related facilities. The program collects fees and insurance premiums from the entities it insures, which are deposited into the Health Facility Construction Loan Insurance Fund. When insured entities default on their loans, the state makes payments instead of the insured entity. In the event the fund fails to pay the principal or interest on any debentures issued, the State Treasurer is required to pay holders out of any money in the state treasury not otherwise appropriated for that purpose. State law requires that the State Treasurer make these payments from the General Fund if necessary.

Governor's Proposal: The proposed trailer bill language would make the funds continuously appropriated from the General Fund would also require issued debentures to bear interest equal to the bond.

Comments: Staff has no concerns with the proposed language. The LAO indicates that a continuous appropriation is reasonable in this case in order to ensure that payments of obligations of the program are made without interruption. However, LAO also notes that the Administration's primary focus should be on continuing to ensure that the fund maintains a sufficient reserve and the Administration should take any necessary steps to ensure the program's financial soundness, such as requesting statutory changes to the program's structure or funding, as relevant.

Staff Recommendation: Adopt placeholder trailer bill language.

Vote:

8860 Department of Finance

Department Overview: The Department of Finance (DOF) is the state's fiscal control agency and acts as the Governor's chief fiscal policy arm.

Budget Overview: The Governor Budget proposes expenditures of $73.1 million and 476.1 positions compared to expenditures of $74.9 million and 476.1 positions in the current year. Proposed General Fund support in the budget year is $35.5 million.

Issues for Discussion / Vote

Issue 1: State Leadership Accountability Act (Trailer Bill Language)

Background: Under current law, the Financial Integrity and State Manger's Accountability Act (FISMAA) of 1983 requires state agency heads to be responsible for the management and maintenance of systems of internal accounting and administrative controls and makes legislative findings and declarations in this regard. The act requires a system of internal accounting and administrative control to include specific elements, including, but not limited to, a system of authorization and recordkeeping procedures adequate to provide effective accounting control over assets, liabilities, revenues and expenditures. The act requires a state agency head to conduct a biennial review and report the results to the Legislature, California State Auditor, Controller, Treasurer, Attorney General, Governor and Director of Finance. Since the act has been in place, there have been substantial changes in government program complexity and a realization of an increased need for monitoring of a broad array of program indices over the last 30 years. In addition, the federal government has provided additional guidelines of appropriate internal controls.

Governor's Proposal: The Administration's proposal would update the oversight and internal control activities of state agencies to reflect current thinking on appropriate levels and focus of internal controls. The update would incorporate additional guidance provided by the Government Accountability Office (GAO) as set forth in the agency's *Standards for Internal Control in the Federal Government*, known as the "Green Book." Internal control helps an entity run its operations efficiently and effectively, report reliable information about its operations, and comply with applicable laws and regulations. The Green Book sets the standards for an effective internal control system for federal agencies.

Currently, the applicable law limits internal controls to accounting and administrative control. The proposal would expand well beyond this to include controls related to fiscal, operational, programmatic, strategic, as well as other factors. It also specifies and mandates objectivity on the part of monitoring processes, and specifies the essential components of an effective internal control system (Control Environment, Risk Assessment, Control Activities, Information and Communication and Monitoring). Finally, the proposal limits, to a certain extent, the recipients of the biennial report, to the most appropriate agencies and bodies (Legislature, State Auditor, Controller, Director of Finance, plus the Secretary of Government Operations).

Staff Comments: Staff has no concerns with the proposal and views the proposal as an overdue update to state requirement regarding internal controls. Currently, the report may not be being distributed to the appropriate legislative office. DOF indicates that this may be addressed administrative rather than in statute, and staff recommends distribution to the Secretary of the Senate, Assembly Rules Committee, and the Joint Legislative Budget Committee.

Staff Recommendation: Approve placeholder trailer bill language.

Vote:

Issue 2: Public Works—State Building Construction (Trailer Bill Language)

Background: Existing law sets forth various requirements regarding public works projects, including: project performance criteria; authorization of the issuance of related bonds; property ownership upon bond retirement; asset transfer authority for financings; and competitive bond sale requirements.

Governor Proposal: The proposed trailer bill language would make various technical changes and provide clarification and updating to various provisions of law. Specifically, the language would:

- Provide technical changes to Public Works Board (PWB) oversight of design build projects, to clarify performance criteria (information that describes the scope of the project) may include concept drawings, which are schematic drawings or architectural renderings. Currently, they are treated as two different components.

- Repeal language that allows for members of the PWB to appoint a deputy to act in their place on the board. The Attorney General's Office has rendered an advice letter concluding that they cannot issue a bond opinion for the issuance of State Public Works Board lease revenue bonds if "a deputy or assistant director" is needed to achieve a quorum at a meeting wherein the PWB authorizes the issuance of bonds.

- Amends statute to correct jurisdiction of property going to the Department of General Services (DGS) for which DGS has no responsibility. This amendment results in increased governmental efficiency by eliminating paperwork by conveying property to the appropriate department when bonds are retired.

- Eliminates the July 1, 2015 sunset date of the PWB's Asset Transfer authority. The asset transfer authority allows the PWB to sell bonds on a completed project (and encumber that facility) and use the bond proceeds to fund the design and or construction of another legislatively authorized project(s). This authority has been used for projects that do not otherwise lend themselves to lease-revenue bond financing.

- Changes the criteria for awarding competitive bond sales. The statutory change would conform to how the state's GO bonds are competitively sold and virtually all long-term fixed competitive sales in today's market, basing such sales on True Interest Cost versus Net Interest Cost. The language also eliminates outdated references to bearer bonds.

Staff Comments: If adopted by the Legislature, the trailer bill language would need to be in a separate stand-alone bill for purposes of a clean bond opinion from the Attorney General for PWB-issued lease- revenue bonds. The proposal also includes an appropriation.

Staff Recommendation: Adopt placeholder trailer bill language.

Vote:

Control Section 6.10 Funding for Deferred Maintenance Projects

Program Overview: Budget Control Section 6.10 gives the Department of Finance the authority to allocate $125 million General Fund in the amounts identified below for deferred maintenance projects:

- University of California.. $25,000,000
- California State University 25,000,000
- Department of Parks and Recreation.. 20,000,000
- Department of Corrections and Rehabilitation 15,000,000
- Department of Food and Agriculture.. 9,000,000
- Department of State Hospitals.. 7,000,000
- Department of Developmental Services 7,000,000
- Department of General Services 5,000,000
- Office of Emergency Services 3,000,000
- State Special Schools... 3,000,000
- Department of Forestry and Fire Protection.. 2,000,000
- California Military Department 2,000,000
- Department of Veterans' Affairs... 2,000,000

Under this proposal, departments would provide DOF a list of deferred maintenance projects for which the funding would be allocated. The DOF would review and provide the approved list to the Chairperson of the Joint Legislative Budget Committee (JLBC) 30 days prior to allocating any funds. The amounts specified above would be available for encumbrance or expenditure until June 30, 2017. If a department made a change to the approved list after the funds have been allocated, DOF' s approval is required and the JLBC would be notified 30 days prior to the change being approved.

Background: The proposed control section is virtually identical (except for the amounts and departments) to that proposed last year as part of the Governor's budget. The adopted budget incorporated a trigger—tied to property tax revenues—which was not activated. At this time, most deferred maintenance is funded through the baseline support budget provided to individual departments. Departments have some discretion to use these funds for maintenance projects or other higher priority needs within the department. In response to this proposal, some departments have provided lists of deferred maintenance projects and identified which projects are the highest priorities for completion. However, other departments have not.

Staff Comments: Given the similarity of the proposal to last year's, staff concerns are equally similar. The Governor's proposal to provide funding for deferred maintenance is a positive first step toward addressing the problem. However, the proposed process for the allocation of the $125 million (which in some cases could be for projects costing tens of millions of dollars) is not likely to provide for adequate Legislative oversight.

The process proposed for allocation of the $125 million would not provide the Legislature with an understanding of how each department prioritized projects. For example, it would be unclear if a department's prioritization process emphasized important factors, such as whether the projects could leverage additional federal or local funds, or if they would help to generate revenue for the state. Project prioritization could also be based on the extent to which the project addresses fire, life, and safety issues, or prevents future greater state costs. Neither would the proposed process allow the Legislature an opportunity to provide its input on other projects that it considers a high priority. Finally, this process would not allow the Legislature to consider other potentially appropriate funding sources for deferred maintenance projects, such as using bond funds or user fees, rather than state General Fund. Given these considerations, the Legislature may want to develop an alternative approach to allocating some of the funding proposed for deferred maintenance projects.

Questions:

Department of Finance

1) Would the proposed funding be in addition to the baseline funding for deferred maintenance included in departments' support budgets, or would this supplant existing funding? Could these funds be diverted to other higher priority activities or will their use be limited to funding deferred maintenance projects?

2) Why were the proposed departments chosen to receive funding and how where the amounts of funding for each department determined?

3) What is the distinction between a deferred maintenance project and a project that has had such significant deferred maintenance that the project has become a capital outlay project? Would these types of capital outlay projects be funded under this proposal?

4) How would the process work if the Legislature has concerns with the projects submitted and approved by DOF?

Legislative Analyst's Office:

1) Does the proposal allow for adequate review of deferred maintenance projects by the Legislature? How could the process be improved?

Staff Recommendation: Hold open.

Vote: