Senate Budget and Fiscal Review— Mark Leno, Chair

SUBCOMMITTEE NO. 4 Agenda

Senator Richard Roth, Chair
Senator Tom Berryhill
Senator Lois Wolk

Thursday, May 9, 2013
9:30 a.m. or Upon Adjournment of Session
Room 112

Consultant: Mark Ibele

Part A

State and Local Finance

Franchise Tax Board
Legislative Analyst's Office
California Budget Project

Proposed Vote-Only Calendar:

Proposed Discussion / Vote Calendar:

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Perspective on Enterprise Zones: Economic and Fiscal Impacts

Presentation from the Franchise Tax Board, Legislative Analyst's Office and the California Budget Project, focusing on the effectiveness of Enterprise Zones and their economic and fiscal impacts.

Franchise Tax Board
- Scott Reid, Manager, Economics and Statistical Research Bureau
- Allen Prohofsky, Chief Economist

Legislative Analyst's Office
- Jason Sisney, Deputy Legislative Analyst, State and Local Finance
- Brian Uhler, Fiscal and Policy Analyst

California Budget Project
- Christopher Hoene, Executive Director

<u>Overview and Purpose</u>

Enterprise Zones (EZs) are geographic areas designated by the state that provide for substantial tax incentives for business activities conducted within their borders. [1] Cities and counties apply to the Department of Housing and Community Development (HCD) for zone designation based on unemployment rates, participation in subsidized meal programs, median resident income, recent plant closures, and certain other socio-economic characteristics. Statutory authority allows for the creation by HCD of up to 42 zones for a 15-year period. Currently, the state has 40 designated zones; two zones were allowed to expire in 2012. EZs are widespread throughout the state and result in various tax benefits for virtually all types of industries. As a result of the various incentives granted by the Legislature through the EZs and other similar programs, the annual revenue impact on the state is on the order of $750 million and growing.

The general intent of the EZ program is to generate, in designated areas, economic activity that would otherwise not occur; however, the effectiveness of the EZ program in this regard is the subject of substantial criticism. EZ critics assert the program offers a poor return on the state's sizable investment due to flaws in the program's specific design and implementation or, more fundamentally, as a consequence of the ineffectiveness and inefficiencies inherent in tax incentive programs of this type. EZ advocates, including numerous business interests and local administrators, argue the program represents California's best tool for economic development. They cite the

[1] Selected tax incentives are also available for certain other designated geographic areas, comprising Local Area Military Base Recovery Areas, Targeted Tax Areas, Manufacturing Enhancement Areas, and Los Angeles Revitalization Zone. These areas constitute a minor portion of the tax incentive participation.

fact that the program results in lower costs for businesses operating in these zones and thus attracts economic activity to disadvantaged or distressed areas of the state.

Budget Perspective

Why consider tax programs—such as EZ tax incentives—in the context of the state budget? The basis for such consideration relates to the concept of tax expenditures.[2] EZ programs, like other special tax provisions, result in beneficial treatment of individuals or businesses who engage in specified activities. The policies that provide this special treatment are known as 'tax expenditure programs' (TEPs), in that they result in the 'expenditure' on a designated program of revenues that would otherwise be received by the state.

The TEP construct draws a parallel between direct expenditures of the state on an activity—for example, expending funds on economic activities in a certain geographic area—and the provision of a tax credit to the private sector for engaging in activities in the area. Thus, from a fiscal perspective, there exists a substantial equivalence between a direct expenditure and tax expenditure. Alternatively, looked at from the taxpayer perspective, elimination of or reductions in TEPs would allow for a broad-based reduction in taxes for all taxpayers while maintaining the same level of revenue.

Although the fiscal similarities are apparent, from a budgetary perspective, there is a significant difference between 'direct' and 'tax' expenditures. Unlike direct spending, TEPs do not come through the legislative budget process, and thus, are not regularly evaluated as to their appropriateness or effectiveness. Some TEPs are of limited duration ('sunsetted') or limited as to the aggregate amount ('capped'), but since TEPs are embodied in the tax code, they generally grow with their associated tax base. Absent a cap or sunset, eliminating or limiting a TEP is typically considered a tax increase. As a result, TEPs are on the equivalent of 'automatic pilot,' similar to a programmatic entitlement.

The growth in EZ tax incentives has been significant and has resulted in increased budgetary pressures. Absent a regular structured forum to evaluate their effectiveness, the state is hindered in its ability to curtail or alter the EZ programs. This means that the growth in these tax programs may be crowding-out the state's ability to fund more effective programs, maintain an adequate budget reserve, or even provide broad-based or other, more effective, targeted tax relief. The growth rate of EZ tax incentives is discussed below.

[2] The tax expenditure concept is widely attributed to Stanley S. Surrey who in 1967, as Assistant Secretary of the US Treasury for Tax Policy, instructed his staff to compile a list of preferences and concessions in the income tax that had the nature of expenditure programs. See Surrey, Stanley S., and Paul R. McDaniel, *Tax Expenditures.* (Cambridge, MA: Harvard University Press) 1985.

EZ Tax Incentives Program Detail

Taxpayers with business activities located in an EZ can claim various tax incentives through both the corporation tax (CT) and the personal income tax (PIT). The available programs include tax credits for hiring certain qualified individuals, sales taxes paid on equipment purchases, and net interest deductions for banks making loans to an EZ business. In addition, EZ businesses may benefit from accelerated depreciation of equipment and the carry-over of 100 percent of business losses to future tax years.

Hiring Credit. The largest EZ-related incentive is the hiring credit. California law provides this credit to taxpayers that employ qualified employees in an EZ during the taxable year equal to: (1) 50 percent of qualified wages in the first year of employment; (2) 40 percent of qualified wages in the second year of employment; (3) 30 percent of qualified wages in the third year of employment; (4) 20 percent of qualified wages in the fourth year of employment; and, (5) 10 percent of qualified wages in the fifth year of employment.

In general, "qualified wages" means wages that do not exceed 150 percent of the minimum wage. A "qualified employee," in turn, means an individual who meets both of the following requirements: (1) At least 90 percent of the individual's work for the taxpayer is directly related to the conduct of the taxpayer's trade or business located in an EZ; and, (2) At least 50 percent of the individual's services for the taxpayer are performed within the boundaries of an EZ.

In addition, a "qualified employee" must fall within at least one of several statutorily designated categories. Listed categories include economically disadvantaged individuals, dislocated workers, disabled individuals, ex-offenders, recipients of certain federal or state aid, members of a federally-recognized Indian tribe, and residents of a "targeted employment area" as defined by Government Code Section 7072. [3]

Finally, to qualify for the hiring credit, the taxpayer must obtain a certification (or "voucher") providing that the employee meets the eligibility criteria specified above. Taxpayers are required to retain a copy of this voucher and provide it upon request to the Franchise Tax Board (FTB), the state agency charged with administering the CT and the PIT.

Sales or Use Tax Credit. Taxpayers engaged in a trade or business within an EZ may take a credit equal to the sales or use tax paid during the taxable year in connection with the purchase of qualified property. Qualified property includes

[3] Targeted Employment Areas (TEAs) may be designated by cities and counties with EZs as census tracts where more than 50 percent of the residents are low and moderate income (defined as 80 percent of the area or county median). Thus, residents of the TEAs are considered qualified individuals for purposes of the EZ hiring credit, regardless of their individual income or employability characteristics.

specified machinery and machinery parts, data processing and communications equipment, and motion picture manufacturing equipment central to production and postproduction. The total cost of qualified property that may be taken into account for purposes of claiming this credit may not exceed $1 million for PIT filers and $20 million for CT filers. Moreover, the qualified property must be used by the taxpayer exclusively in an EZ.

Net Interest Deduction. California law provides for the deduction of net interest income on loans made to a trade or business located solely within an EZ. For purposes of the EZ net interest deduction, a qualified taxpayer (creditor) is defined as an entity that loans funds on or after the designation date of the EZ to a qualified business (debtor) and receives interest payments thereon. It should be noted that the taxpayer (creditor) does not have to be located in the EZ to take advantage of the net interest deduction; only the debtor needs to operate within the EZ.

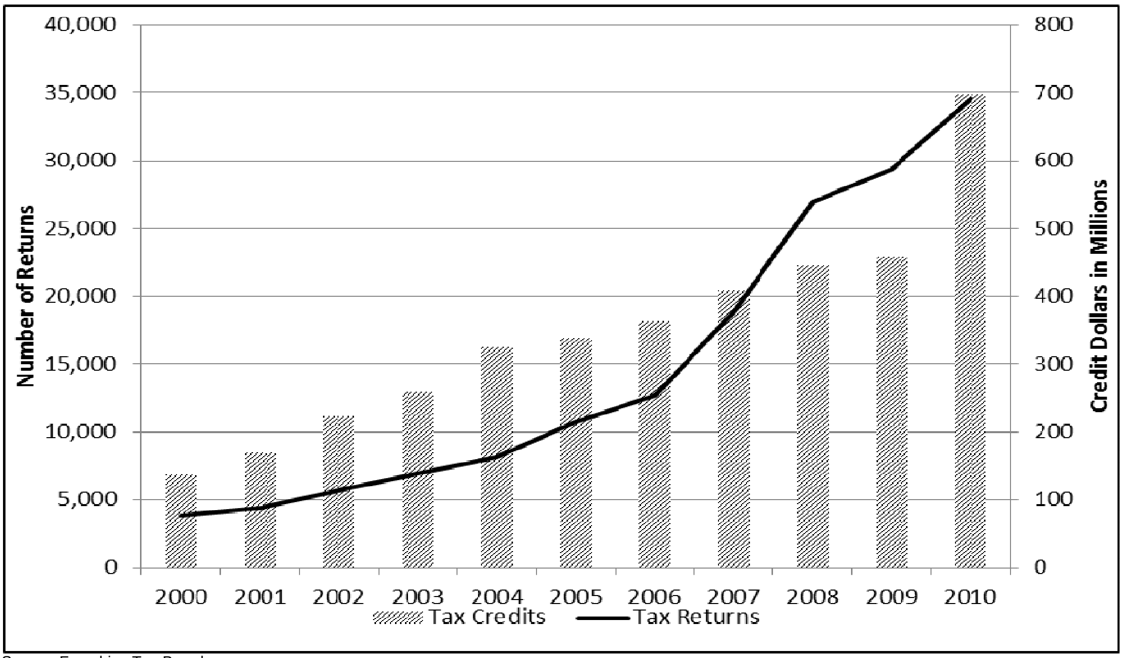
Accelerated Depreciation. Existing law allows EZ taxpayers to treat 40 percent of the cost of specified property as an expense not chargeable to the taxpayer's capital account. Any such cost may be allowed as a deduction for the taxable year in which the taxpayer places the property in service. Such property must be for exclusive use in a trade or business conducted within an EZ.

Employee Tax Credit. Finally, existing law allows an income tax credit equal to 5 percent of qualified wages, as defined, received by a qualified EZ employee during the taxable year. However, for each dollar of income received by the employee in excess of qualified wages, the credit is reduced by nine cents.

Substantial Growth in EZ Tax Incentives

From the perspective of the state fisc, the resource commitment to and budgetary impact of this program has grown quickly and is substantial. According to FTB figures, the combined PIT and CT impact of EZ and related credits was $201 million in tax year 2001 and had grown to $402 million by 2005. Despite the impacts of the steep economic downturn that began in 2008, credit usage continued to increase; by 2010 the annual revenue impact of the EZ program had risen to an estimated $746 million. Over the last decade, increases in EZ costs have been greater than 15 percent annually, even during a period of economic contraction. The growth from 2009 to 2010 was over 50 percent. Capping the program at a certain level, much the same way many direct expenditures are controlled, would limit the state's fiscal exposure. The following chart depicts the number of returns claiming certain EZ credits (line) and the dollar value of the credits claimed (bar) over the last decade.

Enterprise Zone Hiring and Sales and Use Tax Credits
Corporation Tax / Personal Income Tax



Source: Franchise Tax Board

EZ credits are claimed by businesses large and small, but the majority of returns with credit claims stem from businesses with assets of $5 million or less. However, in terms of the value of the credit, the great bulk of credits offered under the various EZ programs are used by larger corporations or other businesses. Based on FTB data, 65 percent of the value of the corporation tax credits went to businesses with assets of $1 billion or more, while 80 percent went to businesses with assets of $100 million and over. Some have suggested instituting a gross revenue threshold that would channel more credits to small business.

The EZ program incentives are used by businesses in a broad array of industries, including construction, trade, manufacturing, and services. The most significant share of credits is used by wholesale and retail trade, which together comprises about 30 percent of the total. Durable and non-durable goods manufacturing constitute another 29 percent of the total usage. Financial and information services constitute an additional 21 percent of EZ incentive usage. Some analysts, who believe that the trade industries may constitute too large a share of the use, have proposed the program be limited to specific industries.

The growth in the program is not only reflected in the credits actually used, but also in the amount of accompanying—and significant—growth in earned but unused credits. Companies may not be in the position to avail themselves of credits earned—for example, due to insufficient tax liability to allow for a complete use of the credit earned. In 2010, while $410 million in hiring and sales and use tax credits were applied to corporation tax liabilities, corporations actually earned $700 million in credits. These accrued credits may be carried-over into future years; currently carry-overs of CT and PIT EZ credits total $2.3 billion.

Effectiveness of EZ Programs is in Question

The preponderance of evidence with respect to the impact of state taxes generally, concludes that while they can have an effect on business location and investment decisions, the impact is quite small and swamped by factors such as labor quality, social and physical infrastructure, and market access. Furthermore, the dominant economic perspective related to tax incentives is consistently critical of their inefficiencies as well as their general lack of effectiveness. With respect to particular tax incentives, such as EZ tax incentives, the research is somewhat mixed; however, as with tax incentives in general, EZ incentives appear in the great bulk of analyses to generate a limited economic response, if any. [4] Fundamentally, in the "on the one hand—on the other hand" world of economics, most objective research indicates that policies such as the state's EZ program do not result in additional overall economic activity in the state, but simply shift business activity and employment around.

There are a number of studies that have examined the impact of overall tax reductions in designated EZs. LAO's review of EZ incentives from a few years ago drew several important conclusions from these studies, including the following:

- Intra-metropolitan location activity is more sensitive to tax differences than is interstate location activity. This indicates that EZs may to a large extent merely result in shifting jobs within a state or region rather than increasing the actual number of jobs in that state or region.

- EZ incentives are most effective in assisting a target area if the EZ does not extend beyond that area. Since EZs may simply shift jobs around, the more narrowly targeted the EZ, the more effective it can be in meeting its objective.

- Hiring credits have a greater impact on job creation than other types of incentives. The existence credit for labor costs can increase the demand for labor and assuming a qualified workforce is available, can result in job creation.

- Significant tax incentives are required to overcome actual or perceived higher operating costs in an EZ. To overcome the costs associated with poor infrastructure and perceived or actual less productive labor, tax incentives offered must be relatively generous in order to stimulate additional economic activity.

[4] The results in this area are somewhat dependent on when the study was conducted, the research methodology employed, and the particular types of program incentives available.

Among some specific studies that have been conducted in recent years, the most noteworthy include the following:

In *"Do California's Enterprise Zones Create Jobs?"* (Public Policy Institute of California; Kolko and Neumark, 2009), the authors compared employment data of EZs and control areas in order to assess the extent to which EZs have created additional employment. The report concluded that program has no statistically significant effect on employment. Although it did not look at the effect of EZs on poverty and unemployment, it is unlikely that these would be positively affected in the absence of increasing employment. The study questions the value in the EZ program given that there is a lack of proven benefit to California.

In *"Government Programs Can Improve Local Labor Markets: Evidence from State Enterprise Zones, Federal Empowerment Zones and Federal Enterprise Communities"* (University of Southern California; Ham, Imrohoroglu and Swenson, 2008), the authors used Census tracts focusing on five labor market variables (unemployment rate, poverty rate, fraction of households with wage and salary income, average wage and salary income, and total employment) as a means of analyzing the impact of EZs. The research concluded EZ designation has positive impacts on local labor markets, but impacts of federal programs were substantially larger than state programs. Curiously, the study found that California EZs had no significant effect on employment, but did have a significant effect on the unemployment rate, poverty rate, and the proportion with wage and salary income.

In *"State Enterprise Zone Programs: Have They Worked,"* (Peters and Fischer, 2002), generally gave a low grade to state EZs in terms of accomplishing their objectives. The authors conclude that EZs have typically little impact overall on new investment and do relatively little to improve job prospects of residents of the EZs. The authors do acknowledge heterogeneity in the data and indicate that the success of individual EZs may be favorable, depending upon specific circumstances.

Other papers from the California Budget Project (CBP), *"Enterprise Zone Program: No Bang for the Buck," (2011)* and the Legislative Analyst's Office (LAO) *"California's Enterprise Zone Program: Prepared for the Senate Committee on Revenue and Taxation"* (2010), focused on the administrative and design inefficiencies of the program.

- The CBP paper notes that EZs credits do not require the creation of new jobs, the majority of EZ credits claimed is on the basis of residency rather than barriers to employment, the EZs are too large to direct economic activity to the areas most in need, and EZ eligibility criteria are too broad.

- The LAO paper concluded the program is expensive and not highly effective and recommends its elimination or restructuring. The report identified weakness in the program such as the lack of a narrowly tailored approach, lack of competiveness for area designation, restrictions on types of employees eligible for the credit, and retroactive credits.

Efforts to Reform EZ Tax Programs

The EZ programs have been the subject of numerous attempts at reform, stimulated by concerns over the growing cost as well as their questionable effectiveness.

Legislative Efforts. There have been numerous legislative efforts to reform the EZ program. In recent years SB 974 (Steinberg, 2010) and AB 1139 (Perez, 2009) proposed to repeal the TEA criterion and so-called 'retro-vouchering,' but nether bill advanced out of the Legislature. In the current session, SB 434 (Hill), proposes a number of reforms to the EZ program, including: eliminating retro-vouchering, requiring net state-wide job creation, establishing quality job requirements, capping the cost of the program, sunsetting the program, requiring legislative review, creating a public database of companies receiving tax benefits, and regulating tax consultants in the area. The bill was passed out of Senate Governance and Finance Committee on May 1.

2013-14 Governor's Budget. As part of the 2013-14 Governor's budget, the Administration proposed certain regulatory changes to the EZ program. The Governor proposes regulatory changes that are intended to eliminate or mitigate some of the most obvious weaknesses and inconsistencies in the program. The proposed regulations are designed to:

- Limit retro-vouchering by requiring all voucher applications to be made within one year of the date of hire.
- Require third-party verification of employee residence within a Targeted Employment Area.
- Streamline the vouchering process for hiring veterans and recipients of public assistance.
- Create stricter zone audit procedures and audit failure procedures.

The proposed regulations will affect primarily revenues from the CT but have a minor impact on the PIT as well. The Administration estimates that the changes will result in increased revenues of $10 million in 2012-13 and $50 million in 2013-14. In addition to these proposed regulations, the Administration has indicated that it will be pursuing further EZ reform through legislation, although to date, no language on the proposed statutory reforms has been made available.

2011-12 Governor's Budget. The 2011-12 Governor's budget took a more dramatic approach by proposing to eliminate all EZ tax incentives for tax years beginning on or after January 1, 2011. The proposed elimination would apply to both newly earned credits and deductions, as well as to unused credits earned in prior years. Local agencies would have been permitted to maintain any applicable local incentives. This proposal was estimated to generate additional state revenues of $343 million in FY 2010-11 and $581 million in FY 2011-12.

The proposal would have significantly changed the way local development efforts are handled by transferring responsibility and authority to local jurisdictions and their voters. Eliminating state tax benefits for EZs was considered a fundamental part of this change. Because the primary benefit of these zones is to shift economic activity from one geographic region within California to another geographic region within California, the Administration noted that they are not of statewide interest. The proposal did not make it out of the Legislature.

Can We Do Better?

Two reforms that have been proposed would greatly improve the functioning of the EZ tax credit as an incentive. The first proposal, included in the Governor's Budget as well as in legislation, addresses the existence of retro-vouchering of employees. This feature allows businesses to claim the credit for a qualified individual for past years of employment prior to the determination of their eligibility. This aspect can result in the EZ credit acting not like an incentive (since the hiring occurred in the past), but rather as a bonus for prior behavior. Regulatory and legislative initiatives would curtail this practice.

The second proposal, incorporated in the legislation mentioned above, would be designed to address the issue of businesses simply shifting jobs around the state to advantage themselves of the EZ credits without actually creating any new jobs in the state. Current legislation would establish a requirement that businesses that avail themselves of the EZ credit create net new jobs in the state instead of potentially receiving the credit for simply replacing displaced employees.

These and other related reforms would improve the state's tax incentive 'bang for the buck.' [5] However, there may be other types of reforms or structural changes that could also be considered by redirecting all or some of the 'costs' associated with EZ tax incentives and essentially reallocating the credit. Some of these alternatives could be potentially designed to provide assistance to localities that use EZ programs intensively. The non-inclusive list below provides a brief description of possible alternatives:

- **Job and Technical Training Programs.** These programs would focus on developing human capital for prospective employees for industries requiring technical expertise.

[5] Another significant reform proposal is to include additional criteria for employment that is eligible for EZ credits by increasing the minimum wages and meeting certain job retention requirements.

- **Manufacturers Investment Credit/Sales Tax Exemption.** A partial sales tax exemption (or equivalent) could be targeted to certain industries or areas and also address the phenomenon of 'tax pyramiding.' [6]
- **State-Wide Jobs Credit.** A statewide tax credit would address the issue of job relocation within the state by allowing for a credit to be used anywhere within the state.

As a cautionary note, the tax system is a blunt policy tool for encouraging specific and targeted economic activity. Even if flaws in the EZ program are addressed, the more fundamental difficulty will remain. The central issue is the limitation of existing policy tools to structure a program that can differentiate between incentive and reward. That is, for a tax program to be effective and efficient in generating the desired response, it should only provide a tax benefit for behavior that occurs solely due to the presence of the incentive. In fact, for the EZ program—like most other tax incentives—substantial tax benefits accrue to businesses that would have undertaken the activity regardless. Any new or redesigned program would need to address this issue to be effective and efficient.

[6] Tax pyramiding occurs when inputs to production are taxed as well as the outputs. For example, when the purchase of equipment used to produce taxable items is itself subject to taxation.

Proposed Vote-Only Calendar

0984 California Secure Choice Retirement Savings Investment Board

Department Summary: The California Secure Choice Retirement Savings Board (CSCRSIB) was established through SB 1234, (DeLeon), Chapter 734, Statutes of 2012. The CSCRSIB was established for the purpose of creating a statewide retirement savings plan for private workers who do not participate in any other type of employer sponsored retirement savings plan.

Issue Proposed for <u>Vote-Only</u>:

1. **Addition of Budget Bill Item 0984-001-8081—Support for California Secure Choice Retirement Savings Investment Board and Budget Bill Language (Spring Finance Letter and Proposed Budget Bill Language):** The Spring Finance Letter (SFL) proposes expenditure authority of $1.0 million to conduct the market analysis related to private pensions specified in SB 1234 associated with the California Secure Choice Retirement Savings Program (CSCRSP). The market analysis is to determine whether the necessary conditions for implementation of the CSCRSP can be met, with such conditions to include likely participations rates, participants' comfort with various investment vehicles and degree of risk, contribution levels and the rate of account closures and rollovers. The expenditure authority is only available based on the receipt of funds from non-profit, private, or federal funding. Budget bill language provides that the expenditure authority over the $1.0 million is also contingent upon the receipt of funding provided through a non-profit or private entity or the federal government.

   Staff Comment: Staff has no concerns with this proposal.

   Staff Recommendation: Approve the SFL and accompanying budget bill language.

   <u>Vote:</u>

8885 Commission on State Mandates

Issue Proposed for <u>Vote-Only</u>:

1. **Mandate Suspensions (Governor's Budget Proposal):** This item was discussed at the April 25 hearing and held open. The Governor's budget proposes the suspension of numerous mandates in order to achieve budgetary savings. Many of these have been suspended for several years, typically as part of the budget process. In general, mandate suspension has not been subject to thorough policy review that would evaluate the costs and benefits of the mandate, but rather have been suspended solely for the purpose of budgetary savings. The policy decision to establish the mandate in the first place has not generally been a substantial component of the discussion.

   Mandates proposed for suspension include mandates suspended in prior years (Group 1), immediate suspension of five new mandates with statewide cost estimates (Group 2), and four new mandates without statewide cost estimates (Group 3). These are discussed separately below.

   <u>Group 1:</u> The mandates proposed for continued suspension are those mandates which have been previously suspended (Group 1). These are listed in the figure below.

Mandates Suspended in Governor's Budget
General Fund
(Dollars in Thousands)

Suspended Mandate Title—Group 1	Amount
Adult Felony Restitution	$0
Absentee Ballots*	49,598
Absentee Ballots-Tabulation by Precinct*	68
AIDS/Search Warrant	1,596
Airport Land Use Commission/Plans	1,263
Animal Adoption	45,321
Brendon Maguire Act*	0
Conservatorship: Developmentally Disabled Adults	349
Coroners Costs	222
Crime Statistics Reports for the Department of Justice & CSRDOJ Amended	160,705
Crime Victims' Domestic Violence Incident Reports II	2,010
Deaf Teletype Equipment	0
Developmentally Disabled Attorneys' Services	1,198
DNA Database & Amendments to Postmortem Examinations: Unidentified Bodies	310
Domestic Violence Information	0
Elder Abuse, Law Enforcement Training	0

Extended Commitment, Youth Authority	0
False Reports of Police Misconduct	10
Fifteen-Day Close of Voter Registration*	0
Firearm Hearings for Discharged Inpatients	156
Grand Jury Proceedings	0
Handicapped Voter Access Information*	0
In-Home Supportive Services II	444
Inmate AIDS Testing	0
Judiciary Proceedings (for Mentally Retarded Persons)	274
Law Enforcement Sexual Harassment Training	0
Local Coastal Plans	0
Mandate Reimbursement Process I	6,910
Mandate Reimbursement Process II (includes consolidation of MRPI and MRPII)	0
Mentally Disordered Offenders': Treatment as a Condition of Parole	4,909
Mentally Disordered Offenders' Extended Commitments Proceedings	7,215
Mentally Disordered Sex Offenders' Recommitments - Verify Name	340
Mentally Retarded Defendants Representation	36
Missing Person Report III	0
Not Guilty by Reason of Insanity	5,213
Open Meetings Act/Brown Act Reform	113,101
Pacific Beach Safety: Water Quality and Closures	344
Perinatal Services	2,337
Personal Safety Alarm Devices	0
Photographic Record of Evidence	279
Pocket Masks (CPR)	0
Post Conviction: DNA Court Proceedings	411
Postmortem Examinations: Unidentified Bodies, Human Remains	5
Prisoner Parental Rights	0
Senior Citizens Property Tax Postponement	481
Sex Crime Confidentiality	0
Sex Offenders: Disclosure by Law Enforcement Officers	0
SIDS Autopsies	0
SIDS Contacts by Local Health Officers	0
SIDS Training for Firefighters	0
Stolen Vehicle Notification	1,117
Very High Fire Hazard Severity Zones	0
Victims' Statements-Minors	0
Voter Registration Procedures*	2,481
	$408,703

LAO Perspective: LAO has raised questions regarding the six mandates slated for suspension by the Governor's budget that deal with elections matters. The LAO recommended that these six mandates identified by an asterisk (*) in the table above not be suspended but rather funded in the budget, along with the direction that the Administration work with counties to explore alternative funding mechanisms.

Staff Comment: No concerns have been raised regarding the continued suspension of these mandates, other than issues noted by LAO. Staff notes that suspending the election mandates would not preclude the Administration from working with counties to explore an alternative funding mechanism, as suggested by LAO. The selected mandates in the figure have been suspended in prior years.

<u>Group 2:</u> The second group of mandates proposed for suspension is made up of five mandates with newly identified cost estimates. These comprise three mandates associated with elections—Modified Primary Election, Permanent Absentee Voter, and Voter Identification Procedures. These three mandates were considered by the committee as a separate agenda budget item. The remaining two mandates with statewide cost estimates are related to public safety—Domestic Violence Background Checks and Identity Theft—and will be considered in Senate Budget Subcommittee #5. Note that these five mandates constitute the so-called "Reserve Builders," the suspension of which generates $111.0 million in General Fund savings.

<u>Group 3:</u> The third group of mandates designated for suspension is made up of four mandates without statewide cost estimates, as yet. One of these mandates—Tuberculosis Control—will be addressed in Senate Budget Subcommittee #3. The remaining three mandates in this group—California Public Records Act, Local Agency Ethics and Interagency Child Abuse and Neglect Reporting—are discussed below.

- **California Public Records Act.** The core provisions of the California Public Records Act (CPRA), relating to the right of residents to inspect public records and receive copies on request, are not reimbursable mandates. The reimbursable mandate portions of the CPRA relate to providing assistance to those seeking records, notification to the requestor regarding whether the records may be disclosed, and expunging home addresses and phone numbers of employees that relate to request. Suspension would not affect the obligations of local governments to comply with the core provisions of the CPRA. LAO recommends that the provisions of the law that constitute mandates be recast as optional 'best practices.' LAO indicates that the statewide costs—when they are provided—are likely to be in the tens of millions of dollars annually.

- **Local Agency Ethics.** The Commission determined that state law makes it mandatory for some local governments (largely general law cities, and certain special districts, that are required to pay compensation) to adopt policies relating to reimbursement of certain expenses and provide ethics training for officials who receive compensation. The Commission found that some activities related to the adoption of policies relating to reimbursement of expenses and provision of ethics training are reimbursable mandates. LAO points out the somewhat puzzling inconsistency of imposing the mandate on local governments (that are required to pay compensation) and not on others. LAO recommends changes in law that would make compensation optional for all local governments (thus removing the mandate) or exclude from the requirement those local governments that are obligated to pay compensation.

- **Interagency Child Abuse and Neglect Investigation Reports.** As discussed in the Senate Budget Subcommittee #3 agenda for April 11, 2013, the Governor's budget proposes to suspend, in 2013-14, parts of the Child Abuse and Neglect Reporting Act (CANRA) that collectively form what is called the Interagency Child Abuse and Neglect Reporting (ICAN) mandate. Suspending this mandate would make local compliance with the provisions of related statutes optional in 2013-14. Assembly Budget Subcommittee #3 rejected the suspension of this mandate.

Staff Comment: There are important policy issues that are imbedded in each of the three mandate programs discussed in this item. LAO's proposal to recast the CPRA mandate as best practices makes policy sense, as it would require local governments to adopt the best practices or, alternatively, announce at the first public meeting that it was not going to adopt best practices. Similarly, for the Local Agency Ethics mandate, there are numerous issues associated with local government compensation and associated ethics that are best left to a policy discussion. The LAO recommended a workgroup to address issues associated with CANRA, which should occur irrespective of the suspension of the mandate.

Staff Recommendation: Approve suspension of all prior suspended mandates identified in Group 1; suspension of the three election mandates identified in Group 2; and suspension of Local Agency Ethics, California Public Records Act, and Child Abuse and Neglect Reporting Act mandates identified in Group 3.

Vote:

7730 Franchise Tax Board

Issue Proposed for <u>Vote-Only</u>:

1. **Enterprise Data to Revenue Project (Governor's Budget BCP#1):** This request was discussed at the March 21 hearing and held open. 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. This request is for a third year of funding for its Enterprise Data to Revenue (EDR) project, which will address the agency's return processing and utilization of data and connect various systems. The request calls for $152.1 million General Fund and 184 permanent positions in 2013-14. The request includes conversion of 26 positions associated with the project from limited-term to permanent. In addition, the proposal includes a placeholder for the department's project needs in 2014-15 of $87.6 million and 36 positions. Of the $152.1 million in 2013-14, $133.5 million is for a vendor payment (for 2014-15, the vendor payment is $68.5 million). EDR is a fixed-price, benefits-funded project in that timing of the vendor payment is contingent on the state receiving additional revenues attributable to the project. Because of flexibility inherent in the contract structure, FTB is requesting encumbrance and expenditure authority for a portion of the 2013-14 vendor payment until 2014-15. Anticipated revenue attributable to EDR is $261.6 million in 2013-14 and $684.6 million in 2014-15.

   Detail of Project: EDR will replace several older FTB information technology systems and streamline other existing systems. Over the long term, the project is expected to generate and safeguard significant state revenues in the high hundreds of millions of dollars. As a result of certain components coming on-line, the project and related activities generated $7.5 million in revenues in 2009-10, $25.4 million in 2010-11, and $115.7 million in 2011-12. The amounts projected for each of these years were $3.8 million, $13.7 million and $65.3 million, respectively. Total cost of the project through 2017-18 is estimated to be $689.9 million, with approximately $398.9 million payable as a vendor payment. Total revenue generated by the EDR project over this period is expected to be roughly $4.7 billion, for a benefit cost ratio of 6.8:1.

   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.

   Main Goals: 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.

Project Components: 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.

Benefits-Funded Approach: FTB indicates that it plans to finance the EDR project using a benefit-funded approach. Contractor payment for system development and implementation will be 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 makes use of revenue gains from reducing the business entity backlog to more than offset costs in 2009-10 through 2012-13. Although these gains could be accomplished regardless of whether project development goes forward, it makes sense to move forward now because cleaning up the backlog is a necessary condition to efficient project development. In subsequent years, the estimates in the project's Feasibility Study Report (FSR) indicate large increases in annual revenue gains that would be more directly attributable to the IT project. From 2011-12 through 2015-16, annual revenue gains increase from $115.7 million to $1.1 billion, while IT project implementation costs increase from $37.0 million in 2011-12 to a peak of $147.6 million in 2013-14 and then decline to $54.3 million by 2015-16. The method of financing EDR is similar to that used by the Employment Development Department for certain technology projects.

Staff Comment: The net benefit of this project (as estimated in the FSR) 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 completion of project phases. Generally, the project has come on-line faster than anticipated. Existing Supplemental Reporting Language requires FTB to report to the Legislature when revenue, costs, scope or schedule variances exceed 10 percent. The committee may ask the LAO and the California Technology Agency (CTA) to comment on the project.

Staff Recommendation: Approve the budget request.

Vote:

0860 Board of Equalization

Issue Proposed for <u>Vote-Only</u>:

1. **Enhancement of E-Services (Governor's Budget BCP#1):** The Governor's Budget proposes $950,000 ($690,000 General Fund) and 4.0 limited-term positions in 2013-14 and 2014-15 to make enhancements to the e-registration system. The additional staff and resources will pay for enhancements to allow taxpayers to register online with more ease and make account maintenance adjustments that are currently handled by BOE staff.

   Background: Additional funding for the department's electronic services expansion has allowed for implementation of a new registration system, electronic filing, and online requests for extensions, relief of penalty and declarations of timely mailing. The BOE expects the savings resulting from the new system to be $13.42 million by the end of 2013-14. Savings from the system for 2008-09 through 2013-14 were or are expected to be redirected. The next step in the electronic services process is to allow taxpayers to make changes to their accounts on-line, including changes in business location, mailing address, business name, officer information, e-mail addresses, and phone numbers.

   Staff Comment: The advantages of electronic services can accrue to taxpayers by increasing convenience as well as reducing costs. BOE indicates that significant savings have occurred through it electronic services efforts, totaling $53.6 million over the five year period ending 2013-14. This is largely through a reduction in staffing resources that are necessary for administration. This item was discussed in subcommittee hearing on March 21 and held open in order to clarify certain budget figures in the BCP.

   Staff Recommendation: Approve the budget request.

   <u>Vote:</u>

Proposed Discussion / Vote Calendar:

0860 / 7730 Board of Equalization / Franchise Tax Board

Issue Proposed for Discussion / Vote:

1. **Civil Proceedings—Limit on Attorney Fees (Governor's Budget Trailer Bill):** This issue was discussed during the March 21 hearing. The Governor's budget proposed budget trailer bill that limit the means through which attorneys may be compensated in suits against the state involving taxation. The statutory change would affect taxes administered by both the FTB and the BOE. Under the bill, the provisions in the tax laws applicable to personal income tax, corporate franchise tax, and sales and use taxes, regarding prevailing party and reasonable litigation costs would be the exclusive means by which litigation costs and attorneys' fees may be awarded against the FTB and the BOE. These provisions would generally be extended to property taxation and other taxes and fees administered by BOE. The provisions would limit fees to $160 per hour (adjusted on the basis of changes in the California Consumer Price Index) unless the court determines that a special factor justifies a higher rate. Certain aspects of the proposed language have been revised, as discussed below under "Staff Comments."

   Background: Current state law provides two methods for determining attorney's fees in tax related cases: the Revenue & Taxation Code (R&TC) which caps attorney's fees at an hourly rate, and the Code of Civil Procedure which uses a multiplier to determine attorney's fees. Prevailing parties are not eligible for payment of attorney fees if the state establishes that its position is substantially justified, based on a 'reasonable person' test. The proposed change in statute would place the state in virtual conformity with the federal government by limiting fees to those determined under the R&TC. Current federal law provides similar provisions to the state R&TC for capping attorney's fees for parties that prevail against the Internal Revenue Service (IRS). The Administration notes that over $2 million in fees have been paid on four cases over the last 10 years under the Code of Civil Procedure.

   LAO Perspective: LAO notes that the proposal may foreclose the option of highly qualified tax counsel based on hourly fee limitation. In addition, it notes that the change may have an effect on limiting legal procedures which might have an equitable purpose.

   Staff Comment: The proposal would not limit, in any way, a taxpayer's right to file a claim for refund for any tax and only regulates the way they pay unrelated third parties seeking refunds on their behalf. In addition, the provisions would not disallow contingency fee structures, but rather address the fees that could be paid under such plans. The proposal apparently addresses a drafting error from 1983 when the state intended to conform to federal law requiring all attorneys' fees related to tax cases to be awarded under the R&TC with an hourly cap versus under the Code of Civil Procedure. The chance that a fee limit could serve to discourage suits that may have a substantial public purpose in clarifying or correcting existing law, has been substantially addressed by the revisions to the proposal. Assembly Budget Subcommittee #4 rejected the proposed trailer bill at its March 19 hearing.

At its March 21 meeting, the Chair directed staff to work with the Administration to refine certain aspects of the trailer bill to address concerns of the subcommittee. Subsequent to this, and based on these recommend consultations, the Administration revised its language in the following manner:

- Raises the statutory attorney fee limit to $400 per hour, from the previous $160 per hour. Courts would continue to be allowed discretion to award higher fees based on special factors.
- Specifies that the state's compliance with the constitutional obligation to defend a statute would not by itself constitute 'substantial justification' for purposes of defending itself against the payment of attorney fees to a prevailing party.
- Allows attorney fees only in situations where the prevailing parties net worth did not exceed $2.0 million, in the case of an individual, and $7.0 million in the case of a business. These are equivalent to the federal thresholds.

Staff Recommendation: Adopt the proposed trailer bill language.

<u>Vote:</u>

7730 Franchise Tax Board

Issue Proposed for Discussion / Vote:

1. **Section 1031—Like-Kind Exchanges (Committee Issue):** This issue was discussed at the March 21 hearing and held open. California's income laws provide for "like-kind exchanges," which allow the owner of qualified business or investment property (such as a building or equipment) to sell the property and purchase other similar property. When the newly-acquired property is sold, the deferred gain on the original property is then subject to taxation. In this manner, the program acts as a means to defer the gain on the sale of property. Qualified property does not include property used for personal purposes (e.g., home or family car), property sold by a business (e.g., inventories), specifically excluded property (such as securities), and certain other types of property. California conforms to federal law with respect to this program.

   Program Detail: There are significant policy and revenue implications of the program. The like-kind exchange program facilitates exchanges of business assets and allows owners of exchanged property to keep the full value of exchanged property invested in their businesses. Without the program, some otherwise productive transactions might not be undertaken in order to avoid having any resulting gains subject to taxation. Thus, the program could facilitate a more efficient use of productive assets by allowing such exchanges to occur *ex tax*. By allowing investors to retain the lower basis in the property, the tax gains deferral in like-kind exchanges can increase the revenue loss of the "step-up" provision of the estate tax. The step-up provision allows the basis of inherited property to increase for tax purposes to its fair market value at the time of death of the original owner. In addition, if the property owner exchanges California property for non-California property, California may never tax the full amount of the gain on the California property because of the inability to ensure income tax compliance with respect to any gain on a sale by a non-resident. Like any other deferral, to the extent taxes are finally imposed, no consideration is given regarding the loss of the use of revenues between the time of the transaction and the date the taxes are paid.

   Alternative Approaches: There are significant compliance issues associated with out-of-state like-kind exchanges, and because of this, the state may never collect the tax liability that may result. Given the compliance issues, at its March 21 hearing, the subcommittee discussed various options for increasing compliance with the like-kind exchanges. Alternative means by which to address the tax avoidance associated with out-of-state like-kind exchanges have been suggested, including:

   - **Holding Period.** Require a holding period on purchased or exchanged property. This would restrict flipping of investment property and reduce the attractiveness of tax avoidance.

- **Reporting Requirement.** Establish an annual reporting requirement for taxpayers who engaged in a like-kind exchange. Similar annual reporting is required of insurance companies regarding the transfer of certain assets, and reporting is required by some states.
- **Deposit Methods.** Institute withholding of capital gains taxes for like-kind exchanges. Alternatively, require the posting of a bond or allowing the state to establish a property lien.
- **Data Collection.** Pursue information and enforcement of like-kind exchanges with federal and state governments to track the event and location of capital gains realizations.

LAO Perspective: In prior years, the LAO has urged the elimination of the like-kind exchange either in whole or in part. As part of its review of the 2008-09 budget, LAO called for limiting the like-kind exchange to in-state properties only. Subsequently, as part of its 2009-10 budget analysis series, LAO recommended a total elimination of the like-kind exchange.

Staff Comment: This issue is not a proposal of the Franchise Tax Board (FTB) or the Administration. At its March 21 hearing, the subcommittee heard from FTB staff and LAO on advantages and disadvantages of alternatives for addressing non-compliance resulting from this program, including the options identified above. At the direction of the subcommittee, staff looked at advantages and disadvantages of the various approaches, through discussions with FTB and the LAO. On the basis of these discussions, and other research, the annual reporting requirement emerged as the most prudent of the approaches. While imposing the least burden on business, this option would ensure that the state has the necessary enforcement and compliance tools available to it.

The proposed trailer bill would require that taxpayers file an information return with the FTB if the property acquired in a like-kind exchange is located out-of-state. The proposed trailer bill language would exclude from non-recognition of income any exchange in which the out-of-state real property is received in exchange for real property located in California, if the taxpayer fails to file the return. FTB indicates that the proposal would result in additional information that would facilitate audit and other enforcement efforts and result in additional direct revenues of approximately $1.0 million and increasing, once the benefits of the program are fully realized. In addition, there would be indirect benefits from increased compliance.

Staff Recommendation: Adopted proposed trailer bill language that would require an annual information return with respect to out-of-state like-kind exchanges.

<u>Vote:</u>

0860 Board of Equalization

Issues Proposed for Discussion / Vote:

1. **Accounts Receivable Growth (Committee Issue):** The Board of Equalization (BOE) maintains an accounts receivable (AR) inventory of assessed and uncollected tax liabilities. Over the period of the economic downturn, BOE's AR inventory has increased dramatically, growing from $725 million in 2007 to $1.8 billion in 2012—a roughly 250 percent increase. The staff devoted to collecting on these unpaid accounts has increased during this period as well (from 396 positions to 473 position), but not sufficiently to manage the magnitude of the increase.

   The increase in the AR inventory has occurred as a result of several contributing factors. Some of the primary factors are the recession has led to decreased ability of businesses to remain current on accounts, legislative changes that have increased the base of taxpayers, and an increase in the size of the underground economy. As a result, the BOE has realized increased resources in the past, equating to 178 positions over the last four years, but the growth in the AR has continued. One concern is that as the accounts age, they become increasingly difficult to collect. Currently, about one-third of accounts are five years or older and over 50 percent are older than three years.

   Proposal Detail: The collection program activities cover a broad assortment of activities including: making required contacts with the taxpayer, offering installment payment agreements to those unable to make the full payment, fielding calls and other inquiries, and pursuing other options such as wage garnishments, keeper warrants, till taps, and finally, prosecutions in some instances. The department has indicated that additional resources could be deployed to work down the existing inventory to more manageable levels. Specially, an additional 97 collector positions in 2013-14 would generate an additional $33.1 million in revenue for a benefit/cost ratio of 2.9:1. Increasing the position authority to 165 in 2014-15 would generate approximately $60 million for a benefit/cost ratio of 3.5:1. BOE notes that the activities of the collectors will incorporate the use of new software components that will facilitate the training of collectors and improve their productivity.

   Staff Comments: As noted, BOE has received increased resources in the recent past for the purposes of working down the AR inventory. However, current resource levels have not adequately addressed the AR buildup and the inventory has continued to grow, Not only does the state lose in terms of access to incurred tax liabilities, but the accounts themselves become increasing difficult to collect as they age. This suggests the prudence of attacking the problem sooner rather than later—due both to the opportunity cost of uncollected accounts and the deterioration in the quality of the AR. Staff notes that the budgeting of additional resources for the AR activity may not be required on a permanent basis and the committee may consider limited-term positions.

Staff Recommendation: Approve 97.4 three-year, limited-term positions and \$11.3 million (\$8.2 million GF) in 2013-14 and 165.5 limited-term positions and \$17.1 million (\$12.4 million GF), to generate state and local revenues of \$33.1 million in 2013-14 and \$59.5 million in 2014-15.

<u>Vote:</u>