SUBCOMMITTEE NO. 4 Agenda

Senator Michael J. Rubio, Chair
Senator Doug La Malfa
Senator Noreen Evans

Thursday, May 26, 2011
10:00 a.m.
Room 112

Consultant: Keely Martin Bosler and Brian Annis

AGENDA PART A

AGENDA – VOTE ONLY ITEMS

AGENDA – DISCUSSION / VOTE ITEMS

Vote Only Calendar

1730 Franchise Tax Board

1. Enterprise Data to Revenue Project

Background. The Franchise Tax Board's (FTB's) tax filing system has not been substantially updated in the last 25 years. In order to modernize the FTB's filing system, the board initiated the Enterprise Data to Revenue (EDR) Project two years ago. This project will introduce a new Personal Income Tax (PIT) and Business Entity return processing system including expanded imaging, data capture, and return validation. Annually, the FTB processes approximately 15 million PIT returns and one million Business Entity returns. Overall, this project will enable FTB to correct erroneous returns in a timelier manner. It will also be more effective at providing data to identify noncompliance patterns and help identify fraudulent activity. This data system will also allow FTB to better prioritize its workload based on highest cost recovery. The FTB indicates that the new system will also expand self-help tools for taxpayers and tax practitioners to improve the filing and payment activities.

The FTB is using an alternate type of procurement for the EDR project that invites bidders to propose a comprehensive solution to address the overall goals outlined by the EDR project, instead of dictating the solution to the bidders. In this type of procurement, the State enters into a contract with a Primary Solution Provider (PSP) and the State works collaboratively with the provider to find a solution that meets the goals of the State. The FTB received proposals last year and chose a PSP in November 2010.

The FTB is also using a benefits based procurement model to acquire the EDR Project and get the best value and business driven solution. This model is based on acquiring innovative 23 solutions to strategic business problems and only compensating the contractor when these solutions deliver new tax revenues and after certain State costs are recouped. Revenue benefits are then shared with the contractor up to a fixed contract amount. Furthermore, the contract is constructed so that the State does not incur upfront expenses to compensate the contractor.

When fully implemented, the FTB estimates that the EDR project will bring in over $1 billion in ongoing revenue annually. This will help to address the $6.5 billion annual tax gap through increased collection of tax revenues that are due to the State but currently unpaid or uncollected for various reasons. Overall, the one-time costs of the PSP contract are estimated to be $398.9 million over the life of the 66-month (5.5 year) contract. This is significantly more than earlier anticipated costs of the project ($234 million). However, the State is now estimating that the proposed solution by the vendor will generate approximately $1 billion more in revenues over the life of the project.

Finance Letter. The Governor's April 1 Finance Letter requests $28.9 million General Fund to support the EDR project in the budget year. Last year, the Legislature approved a $10.2 million request, including 72 new positions. These costs will be more than offset by the additional revenues that the FTB estimates will be received in the 2011-12 fiscal year. The FTB anticipates generating $65.3 million in additional revenues in 2011-12 which is nearly $40 million more than initially anticipated prior to the FTB receiving the PSP solution.

Specifically, the funding requested in the budget year supports the following expenditures:

1. Personal Services. Includes $3.9 million for support of personal services. However, no additional positions are provided in this budget proposal. The department has indicated that it will redirect existing vacant positions to support this proposal in the short term.
2. PSP Contract. Initial compensation benefits ($25 million) to the PSP paid from additional revenues collected due to the implementation of several "early win" deliverables that will result in additional revenues in the first two to 18 months. Some of the early win deliverables are business process changes that do not require the entire information technology solution to be in place, including making changes to the tax forms to adjust for common mistakes related to real estate deductions and adding additional fields of data to the Accounts Receivable Collection System database.
3. Independent Verification and Validation (IV&V) Contract. Funding ($1.3 million) to acquire an IV&V contractor which is a standard practice of the State when entering into contracts for large information technology projects.
4. Cost Reasonableness Contract. Funding ($110,000) for Cost Reasonableness consultant services. This consultant will act as another check and balance on the main PSP contract to ensure that the costs charged to the State in delivering the project are reasonable and not outside the normal industry standards.

Staff Comments. Overall, staff finds that the EDR project has been thoroughly planned and the FTB has obviously done significant work to ready the organization for the implementation of the new system, including a complete documentation of their business processes. However, the proposed solution by the PSP has a considerably different cost and revenue structure than originally estimated. It will be critical that the state monitor how the estimated cost and revenue structure of this project tracks with actual revenues and expenditures. Furthermore, the calculation of the revenues attributable to the EDR project is essential to evaluating the relative value of the PSP contract. This issue was heard and left open at the May 5 Subcommittee #4 hearing pending receipt of the 2010-11 Section 11 request. The Section 11 request is notification to the Joint Legislative Budget Committee that the Department intends to sign the vendor contract – that Section 11 request was received on May 13.

Staff Recommendation. Staff recommends that the Subcommittee approve this budget request.

8860 Department of Finance

1. Office of the Inspector General - Reorganization

Background. The Office of State Audits and Evaluations (OSAE) is an office within the Department of Finance (DOF) that supports DOF in supervising the state's financial and business policies and in conserving the state's rights, interests, and resources. OSAE accomplishes this through independent audits, objective evaluations, and other related services.

May Revision. The May Revision proposes reorganizing and streamlining the responsibilities of the Office of the Inspector General (OIG). As part of this reorganization, the Administration proposes to transfer workload related to inspections of health care services at the state prisons from the OIG to OSAE. The OSAE would be responsible for evaluations of health care in the prisons and would provide reports to the federal court.

Staff Comments. Staff finds that at this time transferring the workload associated with the prison health care audits seems to create some unknown risk in respect to ultimately satisfying the demands of the *Plata* court while achieving minimal savings.

Staff Recommendation. Staff recommends rejecting this proposal, which is conforming to an action being taken by Subcommittee 5 on the overall reorganization of the OIG.

Revenues

1. Maintain Existing Taxes: Realignment

Governor's Budget and 2011 Budget Conference Committee. The Governor's budget proposed a constitutional amendment to maintain the current sales tax and VLF rates for a five year period dedicated to local governments to support **$5.9 billion** in public safety programs that would be realigned from the state to the counties. The 2011 Budget Conference Committee approved this measure in March of this year, as follows:

- **Maintain 1 percent Increase to State Sales and Use Tax.** The State Sales and Use Tax rate was increased from 5 percent to 6 percent effective April 1, 2009. The increase is set to sunset on June 30, 2011. The Governor's budget would extend the 1 percent State Sales and Use Tax for five additional years to support local public safety programs. This proposal is expected to generate $4.5 billion in the budget year.
- **Maintain 0.5 percent Increase to VLF.** The rate of the vehicle license fee (VLF) was increased from 0.65 to 1.15 percent of a vehicle's value, effective May 19, 2009 and will sunset on June 30, 2011. The increase from 0.65 to 1 percent went to benefit the General Fund and 0.15 of the increase was transferred to the Local Safety and Protection Account to fund local law enforcement programs. The Governor's budget would maintain this increase for five additional years to support local public safety programs, including the local public safety programs supported by the 0.15 raised in 2009. This proposal is expected to generate $1.4 billion in the budget year.

May Revision. The Governor has modified the realignment proposal to reduce the public safety programs being realigned by approximately $270 million. The Governor is therefore reducing the revenues dedicated to realignment commensurately. Instead of dedicating all 0.5 percent of the VLF, the Governor now proposes to dedicate 0.4 percent of the VLF to realignment and the remaining 0.1 percent to the General Fund to support schools. The Governor does not propose any changes to the Sales Tax extension.

Staff Recommendation. Staff recommends that the Subcommittee approve the May Revision proposal to modify the allocation of the VLF to reflect the revised realignment proposal.

2. Maintain Existing Taxes: Education

Governor's Budget and 2011 Budget Conference Committee. The Governor's budget proposed a constitutional amendment maintaining the following tax rates for a five year period dedicated to education that will generate **$5.2 billion** annually. The 2011 Budget Conference Committee approved this measure in March of this year, as follows:

- **Maintain 0.25 percent Surcharge.** A PIT surcharge of 0.25 percent was enacted effective in the 2009 and 2010 tax years. The Governor's budget estimates that maintaining this surcharge would generate $3.3 billion in the current and budget years.
- **Maintain Reduced Dependent Exemption Credit.** The dependent exemption credit was reduced from $309 to $99 effective in the 2009 and 2010 tax years. The Governor's budget estimates that maintaining this reduced credit will generate about $2 billion in the current and budget years.

May Revision. The Governor has proposed to reduce the tax package proposed in January by eliminating the 0.25 percent surcharge for the 2011 tax year. The Governor does propose to reinstate the 2010 tax rate in the 2012 tax year for a four year period. This change reduces the tax package by $2 billion relative to the Governor's budget. The Governor does not propose any changes to the dependent credit proposal.

Staff Recommendation. Staff recommends that the Subcommittee approve the Governor's elimination of the 0.25 percent surcharge for the 2011 tax year.

3. Targeted Tax Expenditures: Enterprise Zones

Background. Existing law provides special tax incentives for four kinds of geographically targeted economic development areas. These areas include enterprise zones, local agency military base recovery areas (LAMBRAs), manufacturing enhancement areas (MEAs), and targeted tax areas (TTAs). The tax incentives enjoyed by businesses located in these areas include accelerated depreciation, 100 percent net operating loss carryover, wage credits, and credits for sales tax on equipment purchased for use in the zone. There are some differences among the tax incentives provided for each area, but taxpayers generally have access to each form of preferable tax treatment.

The law currently limits the number of enterprise zones (42), LAMBRAs (8), MEAs (2) and TTAs (1). The Department of Housing and Community Development has designated 42 enterprise zones and 7 LAMBRAs as of December 15, 2010.

Employers within enterprise zones are allowed to claim a tax credit of 50 percent of the wages paid to a qualified employee in the first year, 40 percent in the second year, 30 percent in the third year, 20 percent in the fourth year, and 10 percent in the fifth year, up to 150 percent of the minimum wage. Qualified employees include individuals: (1) eligible for job training programs; (1) eligible for most social welfare programs; (3) economically disadvantaged; (4) dislocated workers; (5) disabled and eligible or enrolled in a state rehabilitation plan; (6) veteran; (7) ex-offender; and (8) member of a federally recognized Indian Tribe. Furthermore, existing law also allows enterprise zones to designate targeted employment areas (TEAs) to contain census tracts where 51 percent or more of individuals are considered low or moderate income. Any hire made out of a TEA can qualify the taxpayer in the enterprise zone for the hiring tax credit and TEAs can be drawn outside the borders of the enterprise zones.

The tax expenditures related to these zones cost the state approximately **$300 million** annually.

Governor's Budget and 2011 Budget Conference Committee. The Governor's budget proposed to repeal the state tax benefits allowed in the four kinds of geographically targeted economic development areas described above. The proposal would have eliminated all state tax benefits for both newly earned credits and deductions and for credits that had been earned in prior years, but have not been used. Local agencies would have the option of keeping their local incentives. This proposal would have generated additional revenues of **$924 million** in the current and budget years. The 2011 Budget Conference Committee also approved this proposal.

May Revision. The Governor's May Revision withdraws the January proposal to repeal the tax benefits for enterprise zones. Instead the Governor proposes to reform enterprise zone hiring credits so that credits are only available to firms which actually increase their level of employment. Under the new hiring credit the taxpayer would be eligible for a $5,000 credit for each incremental full-time equivalent employee that they hire. These credits would be allowed if claimed on the taxpayer's original return.

Furthermore, the May Revision proposal limits a practice known as "retro-vouchering" by not allowing any new vouchers to be granted for tax years prior to 2011 when the application for that voucher was made more than 30 days after the date that the employee first begins employment. The May Revision proposes to limit enterprise zone credits to a five year carry-forward period to ensure that the credit is encouraging relatively profitable businesses.

This proposal would generate additional revenues of **$93 million** in the current and budget years.

Good Goal, But Not a Core State Responsibility. The enterprise zone program was formed in 1984 to help draw investment into depressed rural and urban areas. While this is a good goal, it is not a core responsibility of state government and given the state's chronic budget deficits it is important that all state spending, including tax expenditures be scrutinized. Furthermore, the Governor has proposed a new option for local governments that want to continue to fund economic development activities. Specifically, the Governor has proposed a constitutional amendment to provide for 55 percent voter approval for limited tax increases and bonding against local revenues for economic development projects.

Current Program Not Proven Effective. In addition, the LAO and others have found that enterprise zone tax benefits have little to any impact on the creation of economic activity or employment in California. The LAO found that the program mainly seemed to shift economic activity from one zone to another within California without doing anything to grow economic activity. Furthermore, there is some evidence that benefits from the enterprise zone program go to taxpayers whose behavior has not been affected at all by the program, but instead by firms that specialize in finding businesses that could benefit from the program and offering to prepare the taxpayers tax return on a percent of benefit basis. In these cases it is clear that the taxpayer did not relocate their business because of the enterprise zone – since they had to be told of the tax benefit after they had already relocated.

Reform versus Elimination. Recently there have been significant efforts to make some reforms to the enterprise zone program. Specifically, SB 974 (Steinberg) from 2010 proposed to eliminate Targeted Employment Areas (TEAs) and stop the practice of retro-vouchering. As mentioned above, TEAs allow a taxpayer to qualify an employer for a tax credit not based on who they are, but based solely on residence within a zip code range listed on his or her employment records. Retro vouchering essentially allows taxpayers to gain tax credits for hiring decisions made in the past. Taxpayers often use the TEA criterion and the retro-vouchering to check payroll records and essentially "mine" the data for qualified employees and then file tax claims for refunds with the State.

Staff Comment: With the May Revision, the Governor is proposing to maintain, but reform, the enterprise zone program. The reformed program would become more focused on job creation, which is one of the highest priorities of the state at this time.

Staff Recommendation. Staff recommends that the Subcommittee take the following actions:

- Withdraw the proposal to eliminate all tax incentives in enterprise zones.
- Approve trailer bill language to reform enterprise zone hiring credits.

4. Jobs Tax Credit Expansion

Background. As part of the February 2009 budget package, the Legislature adopted SB X3 15 (Calderon) that included provisions to incentivize small business job creation through a small-business hiring tax credit. The legislation allows a qualified employer to claim an income tax credit of $3,000 for each additional full-time employee hired by the employer during the taxable years 2009 and 2010. Unused credits may be carried forward by the taxpayer to reduce the tax liability over the following eight years. The total taxpayer benefits – and General Fund revenue loss – from the credits is capped at $400 million. The amount of credit is prorated if the employee works fewer than 12 months during the employer's tax year. The credit is only available to a business that has 20 or fewer employees on the first day of the taxable year. When SB X3 15 was adopted, the revenue estimates assumed most of the credits would be both claimed and used to offset tax liability in the short term – reducing State tax revenue in 2008-09 and 2009-10 by a total of $345 million. However, the Administration indicates only about $36 million in credits were used to offset revenue in 2008-09 and 2009-10.

May Revision. The Governor's May Revision proposes to expand the job credit to further stimulate small business job creation. The credit would be extended into the 2011 and 2012 tax years, the credit would be increased from $3,000 to $4,000 per new job created, and the credit would be available to more employers by expanding the definition of small business from 20 or fewer employees, to 50 or fewer employees. Other components of the tax credit would remain unchanged such as the cap of $400 million for the program. Since the credit was not fully allocated in the 2009 and 2010 tax years and would now be extended to 2011 and 2012 tax years, this proposal does result in addition General Fund revenue loss relative to the baseline forecast. The revenue loss in 2010-11 is estimated by the Department of Finance at $29 million and the revenue loss in 2011-12 is estimated at $65 million.

Related May Finance Letter for the BT&H Agency. The Governor is also proposing to augment the budget of the Business, Transportation and Housing Agency (BT&H Agency) by $279,000 General Fund to add one position and fund consulting services, to increase public awareness of the tax credit. The Administration did not provide the typical Finance Letter detail with this proposal that would explain the activities of the new state staff and the consultant.

Staff Comment: While not explicitly linked to other revenue proposals in proposed trailer bill language, this proposal is a new tax expenditure that would reduce General Fund revenues by an estimated $94 million through June 2012. This new tax expenditure program would be difficult to fund in this constrained budget environment unless the Governor's tax extensions and tax policy reforms are also adopted. New General Fund expenditures of $279,000 are proposed marketing the program, but public outreach could also be accomplished within existing state resources such as press officers and Agency Secretaries that could publicize the program with speeches to local chambers of commerce, press events, etc.

Staff Recommendation. Staff recommends that the Subcommittee take the following actions:

- Approve trailer bill language to expand the jobs credit.
- Reject the $279,000 General Fund at the BT&H Agency for marketing the program, and instead achieve improvements to public outreach with existing resources.

5. Sales and Use Tax Exemption—Manufacturing Equipment

Background. For a ten-year period ending December 31, 2003, California law provided a partial (General Fund only) sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. The sales and use tax exemption provided relief of payment of the state tax portion for purchases of qualifying property, and the income tax credit was equal to six percent of the amount paid for qualified property placed in service in California. New manufacturers could either receive the benefit of the exemption, or claim the income tax credit. However, existing manufacturers could only receive the benefit of the income tax credit. This sales and use tax exemption and income tax credit had a conditional sunset date that was triggered when manufacturing employment (as determined by the Employment Development Department) did not exceed manufacturing employment as of January 1, 1994 by more than 100,000 workers. On January 1, 2003, manufacturing employment was less than the 1994 number by over 10,000 workers, and therefore the MIC and partial sales tax exemption expired at the end of 2003.

May Revision. The Governor’s May Revision proposes to provide a new partial sales and use tax exemption for qualified purchases by a taxpayer involved in manufacturing starting July 1, 2012 and ending July 1, 2016. This exemption is similar to the exemption in state law from 1994 until 2003, but has differential exemptions for existing and new manufacturers. It is intended to decrease the cost of doing business for manufacturing companies in an attempt to stimulate investment and employment in those industries and to attract and expand business activity in California. The proposed credit would provide a full 5-percent exemption of the General Fund sales and use tax for new start-up firms and a 1-percent exemption for existing firms. The State General Fund revenue loss from the proposal is estimated at $261 million in 2012-13, increasing slightly thereafter through 2015-16.

Linked to Other Revenues. The proposed sunset for the manufacturers’ tax exemption of July 1, 2016, is linked to the date the temporary taxes would expire. The proposed trailer bill language would make the new tax expenditure contingent on voter approval of a proposition on a future statewide general election ballot related to the tax extensions. These tax extensions are the sales tax and Vehicle License Fee revenues dedicated to realignment (see also agenda issue #1) and the personal income tax revenues dedicated to education (see also agenda issue #2). While not explicitly linked in the proposed trailer bill language, the Governor’s May Revision document indicates the manufacturers’ credit is not affordable unless his proposal is adopted to make the single sales factor mandatory. Note, the single sales factor proposal was adopted by the Budget Conference Committee, and the Governor proposed no change in the May Revision.

Staff Comment: As indicated above, this proposal is a new tax expenditure that would reduce General Fund revenues by an estimated $261 million in 2012-13. This new tax expenditure program would be difficult to fund in this constrained budget environment unless the Governor’s tax extensions and tax policy reforms are also adopted.

Staff Recommendation. Approve trailer bill language to create a new manufacturers’ tax credit contingent on the maintenance of existing taxes.