Board of Equalization:

Policies and Cost Assessment Methods for Special Tax Jurisdictions Need Reconsideration

January 1996

95022

Table of Contents

Summary

Audit Highlights ...

The board:

- ☑ ***Uses a cost model that reflects a significant policy decision to assess its basic, or infrastructure, costs to others.***
- ☑ ***Passed on $157.5 million of infrastructure costs to STJs and local governments during the past three years.***
- ☑ ***Inappropriately charged the STJs nearly $6.6 million during the past three years.***
- ☑ ***Used questionable estimates of workload to calculate STJ direct costs.***
- ☑ ***Used an allocation method that resulted in nearly $1.7 million in over- and undercharges to STJs.***

The Board of Equalization (board) is responsible for administering 21 tax programs that generate a total of more than $30 billion in annual revenue. Among the taxes that the board administers are sales-and-use taxes (sales taxes) which the board administers for the State and for cities and counties, and transactions-and-use taxes (transactions taxes) which the board administers for special tax jurisdictions (STJ). Our review focused on whether the board's charges to STJs for the administration of their tax program were reasonable and equitable. The board uses a cost model comprised of direct costs, shared costs, and central agency costs to calculate assessments for STJs. We describe each of these cost elements in Chapter 1. We noted the following key impacts associated with the board's application of the cost model:

- The cost model reflects a significant policy decision to allocate the board's basic, or infrastructure, costs of operating its tax administration system to STJs and local governments (cities and counties). From fiscal year 1993-94 through 1995-96, the board passed on nearly 28 percent ($157.5 million) of its infrastructure costs to the STJs and local governments. Of this amount, the board assessed STJs $55.4 million to help pay for infrastructure costs. The board would continue to incur these costs even if it did not administer the taxes for these entities.

- While the State and local governments appear to be paying for the board's tax administration system to the degree that they benefit from it (i.e., the proportion of revenue they generate is roughly equal to the proportion of costs they pay), the proportion of costs the STJs pay is nearly twice as much as the proportion of revenue they earn. This occurs because the STJs are assessed a large amount of direct costs associated with the unique nature of their transactions taxes as well as a large amount of shared costs while the State and local governments are assessed few direct costs in addition to their portion of shared costs.The application of the cost model results in assessments to the STJs that are regressive in nature. STJs with tax rates of less than 0.5 percent pay a higher proportion of their revenue to the board for administrative costs than do STJs with tax rates of 0.5 percent because it generally costs the same amount to administer a transactions tax with a 0.1 percent rate as one with a 0.5 percent rate.

Notwithstanding the impacts identified above, we noted the following concerns during our review of the costs the board assessed STJs:

- The board inappropriately charged the STJs for costs associated with its administration of two unrelated statewide sales taxes resulting in the STJs paying nearly $6.6 million in additional charges from fiscal year 1993-94 through 1995-96.

- To calculate part of the costs to assess the STJs, the board used estimates of workload (workload factors) that were either developed without benefit of workload studies or were not updated since they were developed using data from fiscal year 1987-88. Therefore, we are unable to conclude whether these costs were reasonable or equitable.

- The board based its allocations to individual STJs, in part, on proportion of revenue rather than entirely on key indicators of workload such as the number of permits and the number of returns. The board's use of proportion of revenue led to 18 STJs being overcharged by nearly $1.7 million and 11 STJs being undercharged by the same amount in fiscal year 1995-96.

- The board made two minor errors when it calculated the STJ assessments for fiscal year 1995-96.

Recommendations

Because the cost model used by the board reflects a significant policy decision to allocate infrastructure costs to the entities that benefit from the board's tax administration system and because of the impacts caused by the application of the cost model, the State's policy makers should examine whether STJs should bear a percentage of the infrastructure costs associated with the board's administration of sales taxes.To ensure reasonable and equitable assessments to the STJs, the board should:

- Stop charging the STJs for partial costs of administering the two statewide half-cent sales taxes;

- Use workload factors that are based on workload studies;

- Periodically update the workload factors it uses in the model to calculate direct costs;

- Allocate costs to individual STJs based on key indicators of workload, such as the number of permits and the number of returns, rather than proportion of revenue; and

- Correct the minor errors we identified.

Agency Comments

The board states that it has no conceptual disagreement with our findings, the report's recommendations are worthy of further consideration, and it will follow the direction of the Governor and Legislature with regard to any changes in policy.

[Blank page inserted for reproduction purposes only.]

Introduction

The Board of Equalization (board) administers 21 tax programs that generate a total of more than $30 billion in annual revenue. The board's sales and use tax program, administered by its sales and use tax division, is expected to generate $24.9 billion during fiscal year 1995-96. Sales tax applies to all retail transactions not subject to special exemptions provided by law. Use tax applies to the storage, use, or other consumption of tangible personal property purchased at retail without payment of sales tax. As of November 30, 1995, the statewide sales-and-use tax (sales tax) rate was 7.25 percent.

One of the taxes administered by the board's sales and use tax division is the transactions-and-use tax (transactions tax) for special tax jurisdictions (STJ) where voters have approved additional tax assessments. Voters within a specific district can approve a measure authorizing an STJ. Although most are created to finance transportation agencies or authorities, others finance open space protection, hospitals, and libraries. Generally, an STJ district will have the same boundaries as a county; however, some districts have city boundaries. Of the 32 current STJs, 26 have county boundaries, 3 have city boundaries, and 3 are within the City and County of San Francisco. Table 1 presents a listing of the STJs, their tax rates, and their year of implementation.

Administration of the Sales and Use Tax Program

The board also administers the State's 5 percent sales tax, the 1.25 percent local government sales tax, and the two statewide half-cent sales taxes, one for public safety and one for local revenue. Administration of transactions taxes and sales taxes encompasses four elements:

- Registration of taxpayers;

- Processing of tax returns and payments;
- Auditing taxpayers; and
- Collecting delinquent taxes.

Table 1

Special Tax Jurisdictions

Year of Implementation	Jurisdiction	Tax Rate (Percent)
1970	Bay Area Rapid Transit District	.5
1976	Santa Clara County Transit District	.5
1979	Santa Cruz Metropolitan Transit District	.5
1982	San Mateo County Transit District	.5
1982	Los Angeles County Transportation Commission	.5
1987	Alameda County Transportation Authority	.5
1987	Fresno County Transportation Authority	.5
1988	San Diego County Regional Transportation Commission	.5
1988	Inyo County Rural Counties Transactions Tax	.5
1989	San Benito County Council of Governments	.5
1989	San Mateo County Transportation Authority	.5
1989	Sacramento Transportation Authority	.5
1989	Contra Costa Transportation Authority	.5
1989	Riverside County Transportation Commission	.5
1990	San Francisco County Transportation Authority	.5
1990	Imperial County Local Transportation Authority	.5
1990	Santa Barbara County Local Transportation Authority	.5
1990	San Bernardino County Transportation Authority	.5
1990	Madera County Transportation Authority	.5
1991	Los Angeles County Transportation Commission	.5
1991	Orange County Local Transportation Authority	.5
1991	San Joaquin Transportation Authority	.5
1991	Sonoma County Open Space Authority	.25
1991	Santa Cruz County Earthquake Recovery Bond	.5
1992	Calexico Heffernan Memorial Hospital District	.5
1993	Del Norte County District	.5
1993	Fresno Metropolitan Projects Authority	.1
1993	San Francisco County Public Finance Authority	.25
1994	San Benito County General Fund Augmentation	.5
1995	City of Clearlake Public Safety Transactions and Use Tax	.5
1995	Stanislaus County Library Transactions and Use Tax	.125
1995	Tulare County Transactions and Use Tax	.5

Staff in the board’s field offices register taxpayers. Registration enables the board to furnish proper tax forms and instructions to taxpayers for reporting and allocating taxes. Among the board’s sections responsible for processing tax returns are the return analysis section and the local tax section. The return analysis section is responsible for reviewing returns for arithmetic accuracy and questionable tax-exempt deductions, billing for additional taxes due, and providing instructions to taxpayers regarding preparation of tax returns. The local tax section is responsible for the proper allocation and distribution of local taxes to local governments and STJs. It also verifies amounts listed on tax returns and determines whether taxpayers reported the proper amount of taxes for the STJs.

The field audit section's purpose is to ensure uniform compliance with tax laws and to protect the state and local tax base. The board selects taxpayers for audit based on the principle of marginal analysis. Specifically, the selection process is statistically designed to cover the tax base in a manner that will result in audits of those taxpayers most likely to make substantial errors in reporting that will result in tax deficiencies. A tax deficiency is the difference between the self-assessed tax amount and the final determination of the tax amount due after auditing. The board uses factors such as past audit experience, leads, and staff's knowledge of the industry to identify those taxpayers most likely to submit returns that will result in tax deficiencies.

Field offices are primarily responsible for the collection of delinquent taxes. The board uses a computer program to pursue delinquencies of less than $5,000. If the balance due is not remitted within predetermined time frames, the computer program automatically generates and sends a series of increasingly serious notices demanding payment from the taxpayer. Delinquencies of $5,000 or more are assigned to a collector in one of the board's 16 district field offices. The board uses another computer program to increase collections by prioritizing workloads based on a set of criteria developed to determine the probability of collection.

Distinctions Between Sales Taxes and Transactions Taxes

There are two significant distinctions between sales taxes and transactions taxes. First, sales taxes are assessed based on the "point-of-sale" whereas transactions taxes are assessed based on the "point-of-delivery" or "point-of-use." Point-of-sale taxes are based on the tax rate in effect at the location a sale takes place. For example, when a retailer sells an item to a consumer, the retailer is responsible for reporting the tax amount associated with the 7.25 percent sales tax rate in effect in the county. On the other hand, point-of-delivery taxes are based on the tax rate in effect at the location to which the retailer delivers an item, and point-of-use taxes are based on the tax rate in effect at the location an item is first used. For example, if a retailer in a county without an STJ delivers an item to a purchaser who lives in another county that charges a 0.5 percent transactions tax rate, the retailer generally is responsible for reporting not only the tax amount associated with the 7.25 percent sales tax rate in effect at the retailer's location but also the tax amount associated with the 0.5 percent transactions tax rate in effect in the county to which the item is delivered.

The second distinction is that, while the sales tax rate is uniformly applied statewide, transactions tax rates are not. As of November 1995, the sales tax rate in all 58 counties in California was 7.25 percent. However, the rates for STJ transactions taxes ranged from 0.1 percent for the Fresno Metropolitan Projects Authority to 0.5 percent charged by 28 other STJs. Areas that do not have STJs charge only the 7.25 percent sales tax.

The distinctions between the two types of taxes result in costs to the board that it would not incur if it administered only state and local government sales taxes. For example, when auditing, the board not only determines whether a retailer properly reported the sales tax in the county of purchase, but also whether the retailer properly reported the transactions tax, if any, in the county of delivery or first use. Therefore, the board assesses the STJs the entire costs related to auditing the point-of-delivery or first-use nature of the transactions tax in addition to part of the costs related to auditing the sales tax.

The Cost Model

Annually, the board assesses each STJ a portion of its total cost for administering the transactions taxes and the four sales taxes. The board currently determines the assessment amount by applying a cost model. The board uses the same cost model to determine the assessments for the other entities for which it administers sales taxes, namely, the State and local governments (cities and counties). The cost model includes three primary elements: central agency costs, direct costs, and shared costs. We describe each of these cost elements in Chapter 1. Appendix A shows the results of the board's application of the cost model for fiscal year 1995-96.

The Auditor General previously reviewed the cost model the board used to develop a reimbursement rate for STJs starting with fiscal year 1991-92. In a report entitled "The Board of Equalization Needs To Adjust Its Model for Setting Reimbursement Rates for Special Tax Jurisdictions" issued in March 1992, the Auditor General concluded that, although the use of the cost model for calculating a reimbursement rate was defendable, the board needed to refine the model. Specifically, the report recommended that the board:

- Exclude the cost of registering taxpayers, processing returns, auditing retailers, and collecting taxes receivable that are related to counties that do not have STJs from costs that are shared between the State, cities and counties, and STJs;

- Use a workload standard basis for allocating costs between STJs located in counties with one STJ and STJs located in counties with two STJs;

- Incorporate an adjustment mechanism into the model that considers the over- or under-collection of reimbursement amounts during the previous period; and

- Develop a method to better quantify existing workload standards.

The board implemented the first three recommendations but did not implement the fourth.

Overall Increases in Tax Administration Costs

The board's costs for tax administration increased from $163.3 million in fiscal year 1990-91 to $241.0 million in fiscal year 1995-96, an increase of $77.7 million (47.6 percent). Although there are numerous reasons why this increase occurred, three stand out. First, the board included in its budgets $29.7 million in salary increases, including merit salary adjustments. Second, the board included in its budgets $11.7 million to establish new or improve existing computer systems. We describe two of the improvement projects in Appendix B of this report. Finally, during this period, the board included in its budgets $10.3 million for additional auditors and related support staff.

Increases In STJ Assessments

As we show in Table 2, STJ assessments increased from $22.4 million in fiscal year 1990-91 to $39.2 million in fiscal year 1995-96, an increase of $16.8 million (75 percent). Several reasons explain this increase. From fiscal year 1990-91 through 1992-93, STJ assessments increased by a net of $1.9 million, from $22.4 million to $24.3 million. This increase is attributable to increases in the amount of revenue the board estimated the STJs would earn and a reduction in the reimbursement rates established by law. During this three-year period, state law directed the board to calculate assessments by multiplying statutorily-established reimbursement rates by the amounts of estimated revenue. Estimated STJ revenue increased from $1.5 billion in fiscal year 1990-91 to $1.8 billion in fiscal year 1992-93, a $312.2 million increase. Although the effective reimbursement rate for STJs dropped from fiscal year 1990-91 to fiscal years 1991-92 and 1992-93, the substantial increase in STJ revenue caused an overall increase in their assessments.

Table 2

Assessment Amounts (in Millions)
Fiscal Years 1990-91 Through 1995-96

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96
STJs	$ 22.4	$ 25.1	$ 24.3	$ 35.0	$ 37.8	$ 39.2
Local Governments	29.0	27.2	27.4	36.0	39.5	42.0
State	111.9	127.6	143.1	141.4	150.3	159.8

Total	**$163.3**	**$179.9**	**$194.8**	**$212.4**	**$227.6**	**$241.0**

Source: Data supplied by the Board of Equalization.

STJ assessments increased 44 percent (from $24.3 million to $35.0 million) from fiscal year 1992-93 to 1993-94 because the board changed its method of calculating them. Chapter 75, Statutes of 1993, required the board to use the cost model to calculate assessment amounts for fiscal year 1993-94 and annually thereafter rather than using the model to establish rates in legislation. Therefore, instead of basing the assessments on the amount of revenues the board estimated the STJs would earn, as it formerly had, the board now based the assessments on estimates of costs it would incur.

From fiscal year 1993-94 through 1995-96, STJ assessments increased by $4.2 million (12 percent), from $35.0 million to $39.2 million. Increases in the board's costs for processing tax returns and for auditing generally accounted for this assessment growth. During this same period, the costs of the board's tax administration system increased by $28.6 million (13.5 percent), from $212.4 million to $241.0 million.

Scope And Methodology

The Budget Act of 1995 (Chapter 303, Statutes of 1995) mandated our audit of the board's cost assessments to the STJs to identify means of reducing the assessments. Specifically, we were directed to:

- Determine whether the costs the board assessed to the STJs were reasonable and equitable;

- Evaluate the board's efficiencies and economies, including our consideration of eliminating low-priority or noneconomic activities associated with its administration of STJ taxes;

- Identify alternatives to the board's administration of the STJ tax revenues;

- Identify alternatives to the board's allocation of shared costs; and

- Certify whether the charges were equitable, and whether the board has implemented all reasonable economies and efficiencies or if it could achieve additional savings through other means.

To determine whether the costs the board assessed to the STJs were reasonable and equitable, we researched policies concerning the recovery of costs associated with services provided by state departments and California laws concerning recovery of costs from STJs and local governments, analyzed the board's assessments to STJs for fiscal years 1990-91 through 1995-96 and the budget increases for the sales and use tax division, analyzed the cost model the board used to calculate direct costs and shared costs to assess the STJs, and identified and evaluated the impacts of the board's application of the cost model.

To evaluate the board's efficiencies and economies and identify possible low-priority or noneconomic activities associated with the board's administration of STJ taxes, we identified the processes the board used to register taxpayers, process tax returns, audit taxpayers, and collect delinquent taxes; observed these processes to identify activities that the board could change to improve efficiency; and reviewed actions the board is taking to improve efficiency through two computer automation projects currently being implemented and an internal review of its return processing activity. During our observations, we identified no board activities associated with administration of STJ taxes that we would consider low priority or noneconomic. Further, no activities that the board could change to significantly improve efficiency other than those already identified by the board came to our attention. We present the results of our review of the actions the board is taking to improve efficiency in Appendix B.

To identify alternatives to the board's administration of the STJ tax revenues, we reviewed available literature (e.g., journal articles) concerning efforts to privatize government operations. We also reviewed the efforts other states undertook to delegate tax administration responsibilities to local governments or special districts and the degree to which other states or local governments privatized their tax administration operations. We present the results of our review in Appendix C.

In Appendix D, we provide a detailed description of the board's cost model, including how the board calculates direct and shared costs, and allocates costs to individual STJs.

To identify alternatives to the board's allocation of shared costs, we surveyed 13 states to determine how they calculated fees for administering their local taxes. We identified several other methods of calculating fees for administration of taxes. Some states do not charge a fee to local governments or special districts for administering their taxes, while others charge a flat rate per retailer or a percentage of the revenues collected, ranging from 1 percent to 3 percent. None of the states we surveyed assessed a type of cost similar to the board's shared costs.

Chapter 1

A Policy Decision Underlying the Cost Model Used by the Board of Equalization Needs to be Reassessed

Chapter Summary

Although the Revenue and Taxation Code directs the Board of Equalization (board) to assess central agency costs, direct costs, and shared costs to special tax jurisdictions (STJ) to help pay for the board's tax administration system, several factors led us to conclude that the State's policy makers should examine the reasonability and equitability of the cost model used to calculate STJ assessments. First, the cost model reflects a significant policy decision to allocate the board's basic, or infrastructure, costs of operating its tax administration system to STJs and local governments. The board would continue to incur these costs, which are defined as shared costs, even if it did not administer the taxes for these entities.

Second, the application of the cost model creates an apparent imbalance between the proportion of revenue STJs earn and the proportion of costs they pay. While the State and local governments (cities and counties) appear to be paying for the board's tax administration system to the degree that they benefit from it (i.e., the proportion of revenue they generate is roughly equal to the proportion of costs they pay), the proportion of costs the STJs pay is nearly twice as much as the proportion of revenue they earn. This occurs because the STJs are assessed a large amount of direct costs associated with the unique nature of their transactions taxes as well as a large amount of shared costs. On the other hand, the State and the local governments are assessed few direct costs in addition to their portion of shared costs.

Finally, the application of the cost model results in assessments to the STJs that are regressive in nature. Specifically, STJs with tax rates of less than 0.5 percent

pay a higher proportion of their revenue to the board for administrative costs than do STJs with tax rates of 0.5 percent. This occurs because it generally costs the board the same amount to administer a tax with a 0.1 percent rate as one with a 0.5 percent rate.

Background

Section 7273 of the California Revenue and Taxation Code directs the board to assess STJs central agency costs, direct costs, and shared costs to help pay for the board's administration of STJ taxes. It does not, however, define these costs. In the absence of statutory definitions, the chief of the board's financial management division stated that the board applies definitions it developed in conjunction with the Department of Finance.

Central Agency Costs

Central agency costs are those costs incurred by the State's central service departments for activities that benefit all state departments, including the board. Examples of these activities include the state controller issuing warrants and the state treasurer cashing warrants. During fiscal year 1995-96, central agency costs accounted for $1.7 million, or 4 percent, of the $39.2 million the board assessed the STJs.

Direct Costs

Direct costs are those additional costs the board incurs administering the STJ tax program.

Direct costs are defined as those directly associated with each tax program. The board estimates them based on workload standards and other forms of cost measurement. The State and local governments incur few direct costs because the application of the cost model identifies few activities from which only they derive benefits. STJs, however, bear a large amount of direct costs. The direct costs assessed to the STJs represent any additional or incremental costs that the board can identify as being incurred because it administers the STJs' transactions taxes. Concerning direct costs assessed to the STJs, an underlying theme is that the STJs are the only type of entity that receives benefits from the board's workload associated with these costs. A second underlying theme is that the board would not incur these costs if it did not administer the STJs' taxes. Specifically, if STJs did not exist or if some other entity besides the board administered their taxes, the board would not have incurred the direct costs that it assessed the STJs. During fiscal year 1995-96, direct costs accounted for $17.6 million, or 45 percent, of the $39.2 million the board assessed the STJs.

Shared Costs

Shared costs are the board's basic, or infrastructure, costs.

Shared costs are defined as the costs of the board's tax administration system that benefit the State, local governments, and STJs individually and jointly but cannot be separately identified as being directly incurred to support any entity. The board calculates the amount of shared costs by subtracting costs unrelated to administration of the STJs' transactions taxes and local governments' sales taxes, as well as direct costs for the STJs, local governments, and the State from the total costs of its tax administration system. In other words, shared costs are the board's basic, or infrastructure, costs of operating its tax administration system. Therefore, through the use of the cost model, the board allocates a portion of its overall costs associated with registration, return processing, auditing, and collection of delinquent taxes to STJs even though those costs are not directly related to STJ workload. According to the chief of the board's financial management division, the board would still incur these costs if it did not administer taxes for the STJs and the local governments. During fiscal year 1995-96, shared costs accounted for $19.9 million (51 percent) of the $39.2 million the board assessed the STJs.

The Board's Assessment of Shared Costs Raises Questions

The definitions of central agency costs and direct costs used by the board are reasonable.[1] However, we believe that the definition of shared costs used by the board, as

[1] See Chapter 2 of this report for our discussion of problems we found concerning the board's calculation of direct costs.

well as its assessment of this type of cost, is worthy of consideration as to its reasonability and equitability.

The board assesses shared costs to the STJs and local governments because it believes the entities that receive benefits (i.e., tax revenues) from its basic tax administration system should help pay for that system. Because the board distributes tax revenues to the State, local governments, and STJs, it believes that all three types of entities should help pay for the costs the board incurs to administer these taxes over and above any direct costs. The board believes that the cost model distributes shared costs to each entity to the extent that each benefits from its tax administration system.

The Board's Approach Is One of Several Alternatives

Although numerous methods can be used to charge costs to the STJs, there are two basic approaches. The board uses the basic approach of including existing costs when calculating the costs of administering the STJs' taxes. In March 1992, the Office of the Auditor General concluded that, although the board needed to refine and correct its cost model reflecting this approach, its use was defendable because, among other reasons, sharing the costs of the board's tax administration system did not conflict with the applicable state statutes and because the State, local governments, and the STJs all benefited from the system.

The report also concluded that the other basic approach, to charge the STJs for only the incremental or direct costs of administering their transactions taxes, was also defendable. This conclusion was based on the concept that local governments and STJs should have to reimburse the board only for costs that it would otherwise not incur to administer their tax programs. Clearly, the incremental approach is a much less costly alternative to the STJs. If the board had used this approach in fiscal year 1995-96, it would have charged the STJs only $17.6 million rather than $39.2 million.

Shared Costs Are Not Indirect Costs

The definition of shared costs used by the board is not limited to only the indirect costs other state agencies are required to charge when they provide goods or services. Section 8752 et seq. of the State Administrative Manual (SAM) requires departments to recover central service costs, direct costs, and indirect costs whenever they provide goods or services for others, except when statutes prohibit full cost recovery. Although the definitions of central agency costs and direct costs used by the board are similar to the SAM's definitions of central service costs and direct costs, the definition of shared costs used by the board is not the same as the SAM's definition of indirect costs. The SAM defines indirect costs as those support costs that usually benefit more than one cost objective or organizational unit [emphasis added]. The SAM also refers to indirect costs as overhead costs. Examples provided include personnel costs of administrative, supervisory, and executive staff; personnel costs of support units, such as clerical and housekeeping; and operating and equipment costs not included as part of direct costs.

Shared costs include more than the usual overhead and support costs.

The board includes most of the costs associated with its tax administration system not specifically related to either the STJs or local governments in the shared cost portion of the model. The cost model apportions these shared costs to the State, the STJs, and the local governments. Thus, the STJs and local governments are paying for administration costs that extend beyond the SAM's definition of indirect costs. The reasonability and equitability of this merits consideration by the State's policy makers.

Who should pay for infrastructure costs, and to what extent, are policy issues.

Because the statutes do not define shared costs and because both approaches are defendable, the questions of who should pay for the board's infrastructure and to what extent they should pay are policy issues. If it is the State's policy makers' intent that the STJs share in the costs of the board's infrastructure, then the cost model used by the board is generally reasonable and equitable. If, on the other hand, it is not their intent, then the cost model is not reasonable or equitable.

The Cost Model Causes Apparent Disparities

The board's application of the cost model results in several apparent disparities that the State's policy makers should be aware of when considering the model's reasonability and equitability. For example, as Table 3 shows, in each fiscal year from 1993-94 through 1995-96, the board passed on nearly 28 percent of its infrastructure costs to the STJs and local governments. As the chief of the board's financial management division pointed out, the State would incur these costs even if the board did not administer the taxes of the local governments and the STJs.

Table 3

Assessments of Shared Costs
Fiscal Years 1993-94 Through 1995-96
(in Millions)

	1993-94		1994-95		1995-96	
STJ portion of shared costs	$ 16.9		$ 18.6		$ 19.9	
Local government portion of shared costs	31.2		34.3		36.6	
Subtotal	**48.1**	**(27.9%)**	**52.9**	**(27.8%)**	**56.5**	**(27.9%)**
State portion of shared costs	124.6	(72.1%)	137.3	(72.2%)	146.2	(72.1%)
Total Shared Costs	**$172.7**	**(100%)**	**$190.2**	**(100%)**	**$202.7**	**(100%)**

Cost model creates an apparent imbalance between the fees paid and benefits derived by STJs.

The cost model also creates an apparent imbalance between the proportion of revenue the STJs earn and the proportion of costs they bear. Following the board's approach of allocating costs to each entity based on the extent to which it benefits (i.e., receives tax revenues), one would expect that the proportion of revenue that an entity receives would roughly equal the proportion of costs the board assesses. As Table 4 shows, the two proportions for the State and the local governments were within 3 percentage points of each other from fiscal year 1993-94 through 1995-96. This indicates that generally the State and local governments are paying for the board's tax administration system to the extent that they benefit. However, for STJs, the proportion of costs was nearly twice as high as the proportion of revenue.

Table 4

Comparison of Proportion of Revenue to Costs

Fiscal Years 1993-94 Through 1995-96

	1993-94	1994-95	1995-96
STJs			
Proportion of total tax revenue	8.5%	8.3%	8.3%
Proportion of total costs	16.5	16.6	16.3
Difference	(8.0)	(8.3)	(8.0)
Local Governments (1.25 percent)			
Proportion of total tax revenue	16.2	15.8	15.8
Proportion of total costs	16.9	17.4	17.4
Difference	(0.7)	(1.6)	(1.6)
State			
Proportion of total tax revenue	65.0	63.3	63.2
Proportion of total costs	64.3	65.9	66.2
Difference	0.7	(2.6)	(3.0)
Statewide Half-Cent Taxes			
Proportion of total tax revenue	10.3	12.6	12.7
Proportion of total costs	2.3[a]	0.1[a]	0.1[a]
Difference	8.0%	12.5%	12.6%

[a] These amounts are direct costs paid from the State's General Fund. Shared and related central agency costs associated with these two half-cent sales taxes are paid from the revenues generated by the State's 5 percent sales tax, the local governments' 1.25 percent sales tax, and the STJs' transactions taxes. We discuss this issue in Chapter 2.

The State and the local governments pay few direct costs.

This apparent disparity resulted from the STJs bearing direct costs ranging from $16.6 million to $17.7 million from fiscal year 1993-94 through 1995-96 in addition to shared costs ranging from $16.9 million to $19.9 million. On the other hand, the State and the local governments incurred few direct costs in addition to their portion of shared costs. According to the chief of the board's financial management division, the STJs incur a large amount of direct costs because the differences between the STJs' transactions taxes and the State's and local governments' sales taxes force the board to conduct several activities that benefit only the STJs.[2] The State and the local governments incur

[2] We describe the differences between the two types of taxes in the Introduction.

few direct costs because the application of the model identifies few activities from which only they benefit. For example, during fiscal year 1995-96, in addition to direct costs associated with the interagency agreements with the Department of Motor Vehicles and the Department of Housing and Community Development, the State incurred direct costs of $602,000 (which the board did not include in the cost model) associated with the implementation of a tax exemption and the local governments incurred direct costs of $2.0 million associated with the board's local tax section.

Finally, the model results in assessments to the STJs that are regressive in nature. Specifically, STJs that have tax rates of less than 0.5 percent pay a higher proportion of their revenue to the board in the form of administrative costs. As Table 5 shows, STJs with tax rates of 0.25 percent, 0.125 percent, and 0.10 percent paid effective assessment rates that ranged from 3.3 percent to 7.3 percent during fiscal years 1993-94 through 1995-96.[3] STJs with a tax rate of 0.5 percent paid effective rates of less than 2 percent. This occurs because it generally costs the board the same amount to administer a tax with a 0.1 percent rate as one with a 0.5 percent rate. Therefore, those STJs with lower tax rates will pay a higher proportion of their revenues in the form of administrative costs.

Table 5

Effective Assessment Rates for Special Tax Jurisdictions Fiscal Years 1993-94 Through 1995-96

	Effective Assessment Rates		
Tax Rate	**1993-94**	**1994-95**	**1995-96**
0.5 percent	1.85%	1.93%	1.85%
0.25 percent	3.40	3.34	3.50
0.125 percent	N/A	N/A	7.31
0.10 percent	4.89	6.63	6.44

[3] Effective assessment rates are calculated by dividing an STJ's assessment costs by the revenue it generates.

Conclusion

The Revenue and Taxation Code directs the board to assess central agency costs, direct costs, and shared costs to special tax jurisdictions to help pay for its tax administration system. However, we concluded that the State's policy makers should examine the reasonability and equitability of the cost model used to calculate STJ assessments. First, the cost model reflects a significant policy decision to allocate the board's infrastructure costs of operating its tax administration system to STJs and local governments. Second, the application of the cost model creates an apparent imbalance between the proportion of revenue STJs earn and the proportion of costs they pay. The proportion of costs the STJs pay is nearly twice as much as the proportion of revenue they earn. This occurs because the STJs are assessed a large amount of direct costs, while the State and the local governments are assessed few direct costs. Finally, the application of the model results in regressive assessments. STJs with tax rates of less than 0.5 percent pay a higher proportion of their revenue to the board for administrative costs than do STJs with tax rates of 0.5 percent. This occurred because it generally costs the board the same amount to administer a tax with a 0.1 percent rate as one with a 0.5 percent rate.

Recommendation

Because the cost model used by the board reflects a significant policy decision to allocate infrastructure costs to the entities that benefit from the board's tax administration system, the State's policy makers should examine the policy decision. Specifically, they should consider whether it is reasonable and equitable for special tax jurisdictions and local governments to bear a percentage of the infrastructure costs associated with the board's tax administration system.

[Blank page inserted for reproduction purposes only.]

Chapter 2

Some of the Costs the Board of Equalization Assesses Special Tax Jurisdictions Are Unreasonable or Inequitable While Others Are Questionable

Chapter Summary

Our review of the costs the Board of Equalization (board) assessed special tax jurisdictions (STJ) disclosed several problems. First, the board charged the STJs additional costs associated with its administration of two unrelated statewide sales taxes. As a result, from fiscal year 1993-94 through 1995-96, the STJs paid nearly $6.6 million in charges that they should not have. Second, the board used questionable workload factors when it calculated the amount of direct costs to assess STJs; some were developed without benefit of workload studies while others have not been updated since they were developed using data from fiscal year 1987-88. For these reasons, we were unable to conclude whether the direct costs the board assessed the STJs were reasonable or equitable. Third, the board based its allocations to individual STJs, in part, on proportion of revenue rather than entirely on workload indicators. The board's use of proportion of revenue led to 18 STJs being overcharged by nearly $1.7 million and 11 STJs being undercharged by the same amount. Finally, the board made minor errors when it calculated the STJ assessments for fiscal year 1995-96.

STJs Were Inequitably Charged Nearly $6.6 Million for the Board's Administration of Two Other Taxes

According to the reasoning of the cost model used by the board, entities receiving benefits (i.e., tax revenues) from the board's tax administration system should help pay for the system to the extent that they benefit from it. Generally speaking, the board calculates the total amount of shared costs for each type of entity based on the proportion of tax revenue that each receives.[4] From fiscal year 1993-94 through 1995-96, the board administered five taxes: the State's 5 percent sales tax; the STJs' transactions taxes (ranging from 0.1 percent to 0.5 percent of sales depending on the STJ); local governments' statewide 1.25 percent sales tax; and two local governments' statewide half-cent sales taxes, one for public safety and one for local revenue. The board's reasoning dictates that, because it administers these five taxes for the State, STJs, and local governments, these entities should help pay for the costs of administering the taxes.

The Board Does Not Consistently Apply the Reasoning of the Cost Model

To recover its costs associated with administering the five taxes, the board withholds the amount of costs it is owed from the revenue generated by only three taxes. According to the chief of the board's financial management division, the State's General Fund bears the direct cost of administering the two half-cent sales taxes. However, the board does not withhold any revenue generated by the two half-cent sales taxes to cover shared or related central agency costs. Instead, it collects these costs from the revenues generated by the State's 5 percent sales tax, the STJs' transactions taxes, and the local governments' 1.25 percent sales tax. Therefore, STJs are paying the board an additional amount of the revenue generated by their transactions taxes to help support two unrelated sales taxes. From fiscal year 1993-94 through 1995-96, the board assessed the STJs nearly $6.6 million (5.9 percent of the total assessed to STJs) in costs associated with its administration of the two unrelated half-cent sales taxes.

---

[4] See Chapter 1 for a description of shared costs and other types of costs the board assesses STJs.

The decision to recover from STJs the costs of two unrelated sales taxes is unreasonable.

The board does not withhold portions of the revenues of the two half-cent taxes to cover their shared or central agency costs because, although the board is directed by statutes to recover the costs of its administration of the STJs' transactions taxes and the local governments' 1.25 percent sales taxes, according to the chief of the board's financial management division, it has no statutory or legal authorization to recover costs for administering the two half-cent taxes from their revenue. The chief further stated that, in the absence of such authorization, staff of the board and the Department of Finance decided that shared costs could not be assessed against these two taxes. The effect of this decision was to recover the shared and central agency costs associated with administering the two half-cent sales taxes from the revenues of the other three taxes.

We believe the decision to recover costs associated with the administration of the two half-cent sales taxes from the STJs results in costs to the STJs that are neither reasonable nor equitable. First, according to the logic of the cost model, costs should be assessed based on the degree to which the entities benefit from the board's administration. Since the STJs received no additional benefits (i.e., revenues) from the board's administration of the two half-cent taxes, they should not have been assessed additional costs. Second, although the board stated that it had no statutory or legal authority to recover administrative costs from the revenues of the two half-cent sales taxes, it could not provide a statutory or legal authority that enabled it to charge the STJs or local governments for the administration of these two taxes.

The Board Used Questionable Workload Factors To Calculate Direct Costs

The board determined the amount of direct costs to assess the STJs based on inadequately supported or outdated information. The chief of the board's financial management division indicated that the board estimates the amount of direct costs to be charged to STJs because the board's time-reporting system does not enable it to calculate the actual amount of direct costs. This estimate is based on "workload factors" it has developed. However, when it calculated the amount of direct costs to assess the

STJs, the board used some workload factors that were not based on workload studies and others that have not been updated recently. For fiscal year 1995-96, the board assessed the STJs $17.6 million in direct costs. We present an example of how the board uses workload factors in its calculation of direct costs in Appendix D.

Estimates for most direct costs were not based on workload studies or current information.

Previously, the Office of the Auditor General noted that the board did not have workload studies for all direct costs. As the Office of the Auditor General pointed out in its report entitled "The Board Of Equalization Needs To Adjust Its Model For Setting Reimbursement Rates For Special Tax Jurisdictions" issued in March 1992, the board's field audit section estimated, without performing any studies, that when a county has one STJ, the field audit hours increase by 5 percent and when a county has two STJs, the field audit hours increase by 6 percent. The board also estimated that audit time in counties adjacent to STJ counties caused an additional 50 percent increase in audit hours calculated for STJ counties. These three estimates were developed by the board's principal tax auditor and reviewed by board staff in several district offices. The report concluded that an estimate of the incremental time needed to audit in districts that had STJs could be cost-effectively developed based on actual hours in a sample of audits. However, for its calculation of direct costs associated with audits for fiscal years 1993-94 through 1995-96, the board continued to use the three estimates; it did not develop workload factors for audits based on a sample of audit hours. Direct costs associated with field audits comprised $7.3 million (18.6 percent) of the STJs' $39.2 million assessment for fiscal year 1995-96.

We also found that the board has not updated 12 of the 16 workload factors it uses to calculate direct costs associated with the return processing function since it developed them using information from fiscal year 1987-88. One of the 4 remaining workload factors has not been updated since fiscal year 1991-92. Although the absence of recent workload studies prevented us from determining whether the board's use of most workload factors in its calculations resulted in under- or overassessments to the STJs, in one instance, an updated workload factor would have resulted in an additional $302,000 assessment to the STJs during fiscal year 1995-96. Among those not updated are workload factors the board uses to estimate the amount of annual workload STJs generate for several of the board's organizational units and another used to estimate how much work an individual can complete in one year.

To ensure it assesses the proper amount of direct costs to STJs, the board should base its workload factors on studies of workload and should periodically update the factors it uses. Periodic updating is necessary because changes in the board's operations may change the workload factors. Since fiscal year 1987-88, the year from which it used data to develop most of its workload factors, the board has changed some of its operations. For example, according to the supervisor of the return analysis section, in fiscal year 1989-90, the board automated its process for recalculating amounts listed on tax returns and for correcting errors that were previously performed manually. He also stated that in fiscal year 1990-91 the board further automated its billing system, resulting in changes to the processes used by the billing unit within the return processing element.

We cannot conclude that the direct costs charged the STJs were reasonable or equitable.

If the board's use of inaccurate workload factors leads it to assess too many costs to the STJs, the STJs will inappropriately subsidize the board's operations. Likewise, if their use leads the board to assess too few costs, the STJs will inappropriately pay too little. Because the board developed some of its factors without benefit of workload studies and has not periodically updated other workload factors, we cannot conclude that the amount of direct costs the board charged the STJs was reasonable or equitable.

The board contends that it has not conducted workload studies and has not updated all of its workload factors because, according to the chief of its financial management division, it has been in a continual state of change since the Office of the Auditor General issued its report. The chief cited the board's ongoing efforts to improve efficiency as one example of change.[5] The chief also stated that it would not be cost effective for the board to update its workload factors at this time because of its implementation of a computer automation project and its review of the return processing function. The chief stated that, because

[5] We describe the board's ongoing efforts to improve efficiency in Appendix B.

the results of these projects will change the way it operates, the workload factors the board uses to calculate direct costs will change. However, to ensure that it is charging an accurate and equitable amount of direct costs to STJs, the board must periodically update the workload factors it uses.

The Board Does Not Fully Use Workload Indicators To Assess Costs to STJs

The board's method of allocating costs to the individual STJs resulted in some STJs being over- and undercharged. Once the board determines the amount of total costs to assess the STJs, it must then determine how much of these costs to assess each individual STJ. For fiscal year 1995-96, the board determined that it would assess the 32 STJs a total of $39.2 million in administrative costs.

Currently, the board uses key indicators of workload such as the number of permits and the number of returns processed during portions of its calculation of the amount of shared costs to be assessed. For instance, the board uses key indicators to calculate costs associated with workload in counties without STJs. These costs are then subtracted from the total amount of shared costs so that STJs are not charged for activities from which they received little to no benefits. For example, if 15 percent of the permits held by retailers in the state are held by retailers located in counties without STJs, the board would assess 15 percent of its costs for registration to non-STJ counties. The board also uses key indicators to determine the amount of shared costs each of the five groups of STJs will bear.[6] We believe that the board's use of key indicators to calculate these amounts is reasonable and equitable.

However, when the board allocates costs to individual STJs within each group, it bases the allocation on proportion of revenue rather than extending the use of key indicators. For example, if the board estimates that an STJ in one

---

[6] See Appendix D for a description of how and why the board groups STJs to assess costs.

group will earn 30 percent of the revenue earned by all STJs in that group, the board will assess this STJ 30 percent of the costs assessed to that group.

The board's allocation of costs resulted in $1.7 million in over- and undercharges to STJs.

Because the board allocated shared costs to the STJs within each group based on their proportion of revenue rather than key indicators, some STJs are paying more costs than they should while others are paying less. When we recalculated assessment amounts using the board's information for key workload indicators rather than proportion of revenue, we found that, for fiscal year 1995-96, the board has overcharged 18 STJs nearly $1.7 million and has undercharged 11 others the same amount. For example, the board has undercharged the Orange County Local Transportation Authority by $619,000 and overcharged the Sacramento Transportation Authority by $187,000. Table 6 shows the amounts and percentages the board will overcharge or undercharge the STJs during fiscal year 1995-96.

The board has the necessary information available to allocate costs to each STJ based on key indicators rather than proportion of revenue and could readily perform the calculations. The chief of the board's financial management division indicated that the Auditor General reviewed the allocation method and did not recommend changing it. However, we believe the use of key indicators to allocate costs to individual STJs is consistent with the recommendations the Auditor General made and, as our analysis shows, some STJs are paying more costs than they should while others are paying less. Specifically, in fiscal year 1995-96, the board will over- or undercharge 15 STJs by at least $100,000 each and will over- or undercharge 18 STJs by at least 10 percent. For example, the board will overcharge the Fresno County Transportation Authority by $123,000, or nearly 21 percent.

The Board Made Two Minor Errors in Calculation

Notwithstanding the concerns we have with the board's current calculation and allocation processes, the board made two minor errors when it calculated STJ assessments for fiscal year 1995-96 using its current processes. In one instance, the board did not include revisions that its audit division had made to the number of audit hours when it calculated the amount of shared costs for the audit element to be allocated between non-STJ counties and STJs. As a result, STJ counties were overcharged $172,400 for auditing while non-STJ counties were undercharged the same amount.

Table 6

Comparison of Assessments Calculated Using Proportion of Revenue Versus Using Workload Indicators Fiscal Year 1995-96

Special Tax Jurisdiction	Assessments Calculated Using Proportion of Revenue	Assessments Calculated Using Workload Indicators	Amount Over or (Under) Assessed	Percentage Over or (Under) Assessed
Alameda County Transportation Authority	$ 1,234,000	$ 1,046,000	$ 188,000	18.0%
Bay Area Rapid Transit District	2,726,000	2,548,000	178,000	7.0
Calexico Heffernan Memorial Hospital District	28,000	36,000	(8,000)	(22.2)
City of Clearlake Public Safety Transactions and Use Tax	9,000	9,000	0	0.0
Contra Costa Transportation Authority	765,000	585,000	180,000	30.8
Del Norte County District	17,000	28,000	(11,000)	(39.3)
Fresno County Transportation Authority	712,000	589,000	123,000	20.9
Fresno Metropolitan Projects Authority	264,000	264,000	0	0.0
Imperial County Local Transportation Authority	133,000	114,000	19,000	16.7
Inyo County Rural Counties Transactions Tax	26,000	35,000	(9,000)	(25.7)
Los Angeles County Transportation Commission[a]	7,377,000	7,807,000	(430,000)	(5.5)
Los Angeles County Transportation Commission	7,280,000	7,436,000	(156,000)	(2.1)
Madera County Transportation Authority	79,000	115,000	(36,000)	(31.3)
Orange County Local Transportation Authority	3,136,000	3,755,000	(619,000)	(16.5)
Riverside County Transportation Commission	1,218,000	1,113,000	105,000	9.4
Sacramento Transportation Authority	1,280,000	1,093,000	187,000	17.1
San Benito County General Fund Augmentation	23,000	18,000	5,000	27.8
San Benito County Council of Governments	24,000	20,000	4,000	20.0
San Bernardino County Transportation Authority	1,349,000	1,248,000	101,000	8.1
San Diego County Regional Transportation Commission	2,754,000	2,611,000	143,000	5.5
San Francisco County Public Finance Authority	819,000	721,000	98,000	13.6
San Francisco County Transportation Authority	867,000	843,000	24,000	2.8
San Joaquin Transportation Authority	461,000	433,000	28,000	6.5
San Mateo County Transit District	739,000	626,000	113,000	18.1
San Mateo County Transportation Authority	733,000	630,000	103,000	16.3
Santa Barbara County Local Transportation Authority	403,000	426,000	(23,000)	(5.4)
Santa Clara County Transit District	1,830,000	1,973,000	(143,000)	(7.2)
Santa Clara County Transportation Authority[b]	1,828,000	1,963,000	(135,000)	(6.9)
Santa Cruz County Earthquake Recovery Bond	188,000	151,000	37,000	24.5
Santa Cruz Metropolitan Transit District	189,000	157,000	32,000	20.4
Sonoma County Open Space Authority	381,000	479,000	(98,000)	(20.5)
Stanislaus County Library Transactions and Use Tax	366,000	366,000	0	0.0

Total 1995-96 STJ Assessments	**$39,238,000**[c]	**$39,238,000**	**$ 0**[d]

[a] Los Angeles County assesses two separate transactions taxes, both of which are associated with the Los Angeles County Transportation Commission. This tax was implemented in 1982 while the other was implemented in 1991.

[b] Although the board calculated this charge for the Santa Clara County Transportation Authority, it did not assess the amount because the STJ did not come into existence.

[c] The $39.2 million assessment, as calculated by the cost model, does not include a $207,000 net decrease to compensate for the board's overcollection of costs during fiscal year 1993-94. This adjustment affected some STJs more than others.

[d] The net effect of this allocation method for all 32 STJs is zero. However, the effect on individual STJs is an overassessment of $1,668,000 for some STJs and an underassessment of the same amount for others.

Also, when the board was calculating the amount of shared costs for collections to be allocated between non-STJ counties and STJ counties, it counted certain collections for one county twice as an STJ county. As a result, STJ counties were overcharged $6,700 for collections while non-STJ counties were undercharged the same amount.

Conclusions

Our review of the costs the board assessed STJs disclosed several problems. For example, the board charged the STJs for some costs associated with its administration of two statewide half-cent sales taxes. As a result, the STJs paid nearly $6.6 million in charges that they should not have from fiscal year 1993-94 through 1995-96. Also, the board used questionable workload factors when it calculated the amount of direct costs to assess STJs. These factors were questionable because the board developed some without benefit of workload studies and has not updated others since they were developed using data from fiscal year 1987-88. Because the board used these questionable workload factors, we cannot conclude whether the direct costs the board assessed the STJs were reasonable or equitable. Moreover, the board based its allocations, in part, on proportion of revenue rather than on key indicators of workload. The board's use of proportion of revenue led to 18 STJs being overcharged nearly $1.7 million and 11 STJs being undercharged the same amount. Finally, the board made two minor errors when it calculated the STJ assessments for fiscal year 1995-96.

Recommendations

To ensure reasonable and equitable assessments to the STJs, the Board of Equalization should:

- Stop charging the STJs for partial costs of administering the two statewide half-cent sales taxes;
- Use workload factors that are based on workload studies;
- Periodically update the workload factors it uses in the model to calculate direct costs;
- Allocate costs to individual STJs based on key indicators of workload rather than proportion of revenue; and
- Correct the minor errors we identified.

We conducted this review under the authority vested in the state auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope of this report.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

Date: January 3, 1996

Staff: Karen L. McKenna, CPA, Audit Principal
Dale A. Carlson, CGFM
Carey G. Gilmour
Brian Lewis, CPA
Phyllis Miller, CPA

[Blank page inserted for reproduction purposes only.]

Appendix A

The Board of Equalization's Computation of Assessment Amounts Fiscal Year 1995-96

Cost Category	State	Cities and Counties (1-1/4%)	Special Tax Jurisdictions	Total
Shared Cost	$146,217,559	$36,578,041	$19,903,238	$202,698,838
Direct Cost:				
Various cost centers			6,011,336	6,011,336
Local tax section		2,008,217	2,140,992	4,149,209
Field audits			7,263,642	7,263,642
Audit section			679,375	679,375
Subtotal Direct Costs	0	2,008,217	16,095,345	18,103,562
Central Agency	6,828,000	1,802,000	1,681,000	10,311,000
Other Direct Cost:				
Department of Motor Vehicles	6,535,952	1,635,045	1,493,903	9,664,900
Department of Housing and Community Development	18,868	4,720	64,112	87,700
Subtotal Other Direct	6,554,820	1,639,765	1,558,015	9,752,600
Total Costs[a]	**$159,600,379**	**$42,028,023**	**$39,237,598**	**$240,866,000**

[a] The STJ total does not include a decrease of $207,000 to adjust the assessed costs for fiscal year 1993-94. The board makes this adjustment annually to compensate for the over- or underallocation of costs. Further, the total for all three entities does not include $212,000 from the State's General Fund for the two statewide half-cent sales taxes.

Appendix B

Actions the Board of Equalization Is Taking to Improve Efficiency

As part of our audit of the Board of Equalization (board), we considered and evaluated economies and efficiencies in its administration of taxes for special tax jurisdictions (STJ). The board has recognized that certain inefficiencies currently exist in the way it does business, and as a result, has pursued various projects to improve its processes. We examined documentation for two ongoing automation projects and one project the board is undertaking to improve the cost efficiency of its tax administration system. However, we did not assess the viability or progress of any of these projects.

Transfer of the Board's Central Computing Systems

One of the projects involves the transfer of the board's central computing systems, including data storage, to the State's Teale Data Center, while retaining certain computing activities at the board. The project evolved as a result of several problems with the current system. These problems included an outdated
and inflexible computer architecture created by repeated modifications of files and processes within the present structure. Additionally, the current system was operating at above rated capacity, with an estimated cost of $35 to $45 million to replace the mainframe. Also, the board's ability to process and deliver timely information was at risk. The board acknowledged that these difficulties resulted in data redundancies, limited the usefulness of the current system, and posed potential risks to its ability to collect revenue. The transfer to the Teale Data Center is designed to result in faster processing time and an updated, integrated, and centralized computer system with the ability to handle necessary tasks. The project is scheduled for completion in May 1997.

The Automated Compliance Management System

The board believes that the Automated Compliance Management System (ACMS) will improve efficiency by assisting collectors in prioritizing and managing collection workloads. According to the board, the ACMS should help the limited number of field staff keep pace with the growing number of accounts, which increased 81 percent from fiscal years 1988-89 to 1992-93, while collection staff increased only 19 percent for the same time period. The board expects the automation to increase productivity, which has been limited due to decentralized, paper-dependent processes. The board believes that problems, such as an overloaded mainframe, limited supervisory resources, and limited access to debtor information, will also improve as a result of the ACMS implementation. The board expects the ACMS to increase revenue collection by $205 million over its six-year project life and improve collection efficiency by reducing the amount of paperwork, increasing taxpayer compliance, reducing delinquent account additions, and improving employee performance measurement. The ACMS project is currently in the system development phase, and the board plans to have it fully implemented in fiscal year 1996-97.

The Return Processing Reengineering Project

The Return Processing Reengineering Project (project) involves identifying processing delays, finding ways to streamline return processing, identifying methods to correct unreliability of electronically stored tax data, and redesigning tax forms. The goal of the project is to determine how the return processing function operates, identify any problems and inefficiencies, and then make both short- and long-term suggestions for improvement. As of November 1995, the project did not have a set completion date.

These projects will result in increased short-term costs to the STJs during development and implementation. However, the documentation we reviewed indicates that efficiencies achieved through the transfer of computing services to the Teale Data Center, implementation of the ACMS, and identification of how to improve the return processing function will benefit the State by ultimately resulting in increased revenue or avoided costs. Presumably, then, the projects would also benefit the STJs, since they are a part of the State's tax administration program. However, although all of the projects have designated benefits, the board provided quantifiable information for only the ACMS project.

Appendix C

Alternatives to the Board of Equalization's Administration of Taxes for Special Tax Jurisdictions

One of the purposes of our audit was to consider and evaluate alternatives to the Board of Equalization's (board) administration of sales taxes associated with special tax jurisdictions (STJ). Although the California Revenue and Taxation Code currently requires STJs to contract with the board for administration of their taxes, we considered two options: delegation of administration responsibilities to the STJs and contracting with private firms for some or all of the administrative functions. We surveyed 13 states to determine who administers their local sales taxes, the degree to which they delegate or privatize their tax administration functions, and benefits or problems associated with delegation or privatization. These 13 states were Alabama, Arizona, Arkansas, Illinois, Louisiana, Minnesota, Missouri, Nevada, New York, Ohio, Texas, Utah, and Washington.

Delegation

Although none of the thirteen states in our survey delegated tax administration functions to special districts or other similar jurisdictions that had taxing authority, local governments in Alabama, Arizona, Louisiana, and Minnesota have some responsibilities for administering local taxes. In Alabama, the state delegates responsibility for administration of local sales taxes to approximately 160 of its cities or counties. Discussions with representatives in Alabama disclosed no major problems associated with delegation. According to a representative of one county in Alabama, the county supports delegation because it enjoys increased control over the taxing functions. She also stated that she could not name any specific problems associated with delegation. The president of a private firm that handles all tax administration functions other than auditing for 65 cities and 2 counties in Alabama identified only one problem: the lack of a single, multi-purpose form that the company could provide to retailers in various cities and counties for reporting tax information. He added that his company is currently developing one.

Louisiana delegates almost all tax administration responsibility to its parishes (counties).[7] The deputy director of an association of local governments in this state explained that parishes experienced possible problems with retailer compliance with tax laws, with political connections between retailers and local politicians, both of which caused lost revenue, and with delays in distributing revenues from the entities that collected it. She concluded, however, that parishes generally enjoy autonomy over their tax administration.

Privatization

Three of the 13 states we surveyed contract with private firms for certain portions of their administration of local sales taxes. For example, Missouri contracts with firms and assigns them certain tax accounts from which it is difficult to collect revenues. A representative explained that it is more cost effective to use contractors because of the low possibility of collection from the accounts and because of savings realized by not using the services of regular state employees. Also, Texas hires telephone collectors to pursue non-filers and low-dollar accounts. It experiences savings due to not bearing the expense of benefit packages for the contracted telephone collectors. We also found examples of cities or counties that contracted for portions of their tax administration. The functions most often contracted out by the local governments we contacted were auditing and collection of delinquent taxes. For example, in Alabama, most local governments contract for audits of retailers.

A representative we spoke with identified a problem associated with local governments privatizing aspects of tax administration. Specifically, a representative of a local government association in Louisiana mentioned difficulties

[7] The only exception is the motor vehicle sales and use tax, which the state administers.

with auditors occasionally overcharging local entities. Although the representative was unable to quantify the problem, she stated that it did not appear to occur on a large scale.

Potential Problems

Aside from the survey results, potential problems came to light that may arise with delegation or privatization. For example, local governments may experience difficulties, such as duplication of administration or increases in non-filing due to taxpayers assuming it is easier to evade local taxing authorities than it is the states' authority. Difficulties with registration of retailers, such as inadvertently omitting retailers, may also occur. Furthermore, contractors may have more problems enforcing tax laws because of their perceived lack of authority. Government entities may also experience difficulties in finding suitable contractors to perform the tax administration functions they wish to privatize.

Finally, we should point out that the sales taxes administered by local governments in the states we contacted generally are "point-of-sale" taxes.[8] Because taxes that are assessed based on point-of-use or point-of-delivery provide revenue that may be generated from outside the jurisdiction, potentially serious concerns, such as the inability to efficiently and effectively audit retailers outside the jurisdiction, could arise if administration of these types of taxes is delegated to an entity other than the State.

Presumably, there are cost savings when transactions are performed on a statewide scale, but there are also benefits, as evidenced by our survey, to local governments administering their own tax programs or contracting out for it. Further study regarding the specific costs and related benefits of delegation and privatization would be needed before these options are pursued.

---

[8] Taxes administered by local governments in Louisiana are "point-of-delivery" taxes. See the Introduction for our discussion of the differences between "point-of-sale" taxes, "point-of-delivery" taxes, and "point-of-use" taxes.

[Blank page inserted for reproduction purposes only.]

Appendix D

Methods the Board of Equalization Uses To Calculate Assessments for Special Tax Jurisdictions

The Board of Equalization (board) uses a complex cost model to calculate direct costs and shared costs for special tax jurisdictions (STJ). Generally speaking, the board calculates direct costs based on workload factors and other forms of cost measurement while it calculates shared costs using both proportion of revenue and key indicators of workload such as the number of permits and the number of returns processed.

Calculating Direct Costs

The board assesses direct costs to the STJs for the return processing and audit elements of its tax administration system. To determine the amount of direct costs for the various sections and units within these elements, the board uses a series of calculations. For example, to calculate the direct costs for STJs associated with the correspondence unit within its return analysis section, the board first calculates the amount of annual workload generated by the STJs (total annual STJ workload). According to the chief of the board's financial management division, "total annual STJ workload" represents the number of lines on tax returns that pertain only to STJs. As we show in Table 7, for fiscal year 1995-96, the board estimated "total annual STJ workload" to be a little more than 5 million lines. Next, the board multiplies this amount by the percentage of "total annual STJ workload" that generates workload for the correspondence unit (workload factor #1). This calculation results in an estimated amount of annual STJ workload for the unit. In fiscal year 1995-96, the board estimated that, since 1.5 percent of the "total annual STJ workload" would generate workload for the correspondence unit, the total annual workload attributable to STJs was 75,100 correspondence items (e.g., letters and memoranda).

Table 7

Calculation of Direct Costs for the Board of Equalization's Correspondence Unit Fiscal Year 1995-96

Line Number	Calculation Element	Amount
1.	Total annual STJ workload	5,006,666 lines
2.	Percentage generating workload for the correspondence unit (workload factor #1)	1.5%
3.	Amount of annual STJ workload for the correspondence unit (line 1 times line 2)	75,100 correspondence items
4.	Annual number of items processed per personnel year (workload factor #2)	2,558
5.	Personnel years necessary to handle STJ-related information (line 3 divided by line 4)	29.4
6.	Annual cost per personnel year	$69,591
7.	Total costs to STJs for the correspondence unit (line 5 times line 6)	$2,045,975

The next step the board takes is to divide the total annual workload attributable to STJs by the number of items a staff person can process during the year (workload factor #2) to determine the number of personnel years (PYs) necessary to process STJ-related information.[9] For 1995-96, the board used 2,558 items as the workload factor for the correspondence unit, resulting in 29.4 PYs necessary to process STJ-related information. Finally, the board multiplies the number of PYs necessary to process STJ-related information by the cost per PY. For 1995-96, the board multiplied the 29.4 PYs by $69,591 to arrive at a

[9] A personnel year is the actual or estimated portion of a position expended for the performance of work. For example, a full-time position which was filled by an employee for half of a year would result in an expenditure of 0.5 personnel years.

total direct cost to the STJs for the correspondence unit of more than $2 million.

The board uses similarly complex calculations to determine the amount of direct costs for the seven other sections within the return processing element and for two areas within the audit element. In total, the board uses 21 separate workload factors when calculating the amount of direct costs to assess the STJs. In Table 8, we show a breakdown of the direct costs the board assessed the STJs during fiscal year 1995-96.

Table 8

Direct Costs Assessed to Special Tax Jurisdictions Fiscal Year 1995-96

Element of Direct Costs	Amount of Direct Costs		Percentage of Total Direct Costs	
Return Processing				
Local Tax Section	$2,140,992		12.1%	
Return Analysis:				
Verification	1,550,305		8.8	
Billing	731,027		4.1	
Correspondence	2,045,975		11.6	
Central Files	880,680		5.0	
Word Processing	420,910		2.4	
Accounting	331,727		1.9	
Account Reference	50,712		0.3	
Subtotal		8,152,328		46.2
Audits				
Field Audits	7,263,642		41.1	
Audit Section	679,375		3.9	
Subtotal		7,943,017		45.0
Other Direct Costs				
Department of Motor Vehicles	1,493,903		8.5	
Department of Housing and Community Development	64,112		0.3	
Subtotal		1,558,015		8.8

Total Direct Costs	$17,653,360	100.0%

Calculating Shared Costs

To calculate shared costs, the board determines the amount of its costs for each of the four elements of the tax administration system that will be shared by the State, local governments, and the STJs, and the proportion of total shared costs it will assess the STJs.[10]

To determine the amount of costs to be shared, the board starts with the amounts the Governor's Budget allocates for each of the four tax administration elements. The board subsequently revises these amounts based on adjustments reflected in the annual Budget Act. As we show in Table 9, the total for the four elements for fiscal year 1995-96 was $233.9 million. From this amount, the board subtracts two types of costs. First, the board subtracts amounts that are unrelated to its administration of the STJs' and local governments' taxes so that it does not charge costs from which the STJs and local governments do not benefit. Second, the board subtracts the amounts of direct costs it will assess the STJs and local governments so that it does not double charge them. For the STJs only, the board subtracts a third type of costs; specifically, those associated with its work in counties that do not have STJs. The board deducts these costs so that it does not charge costs from which the STJs will receive little to no benefit. The board later distributes these "non-STJ-county" costs to the State and local governments. In fiscal year 1995-96, the total amount of costs to be shared among the State, the local governments, and the STJs was $181.6 million.

To calculate the proportion of total shared costs it will assess the STJs, the board first estimates the amount of revenue to be generated from each of the five taxes it administers.[11] As we show in Table 10, for fiscal year 1995-96, the board estimated that the five taxes would generate $24.9 billion. Next, the board subtracts the revenue it estimates will be earned from the two statewide

[10] We describe the four elements of the board's tax administration system in the Introduction.

[11] We describe the five taxes the board administers in the Introduction.

half-cent sales taxes. The board does this because it does not withhold portions of the revenues from these two taxes to help pay for its tax administration system. We discuss this problem in Chapter 2. After subtracting the estimated amount of STJ revenue, the board multiplies the remaining amount by the percentage of dollar value of sales occurring in counties with STJs. Since the board does not charge the STJs for its work in counties that do not have STJs, the board believes that it is more equitable to calculate the

Table 9

Calculation of Costs To Be Shared Between the State, Local Governments, and Special Tax Jurisdictions Fiscal Year 1995-96 (in Millions)

Calculation Element	Registration	Return Processing	Audits	Collection	Total
Total tax administration budget	$36,523	$55,094	$110,096	$32,225	$233,938
Less unrelated costs	(37)	(2,645)	(498)	0	(3,180)
Less direct costs for STJs and local governments	0	(19,983)	(8,076)	0	(28,059)
Less costs incurred in counties without STJs	(6,144)	(5,166)	(6,195)	(3,583)	(21,088)
Total	**$30,342**	**$27,300**	**$ 95,327**	**$28,642**	**$181,611**

proportion of STJ revenue by using only the total revenue earned in counties with STJs rather than the total revenue earned throughout the State. The board then adds the estimated STJ revenue into the subtotal to arrive at the adjusted amount of total revenue generated from the taxes. To calculate the proportion of STJ revenue, the board divides the estimated amount of STJ revenue by the adjusted amount of total revenue. The board then multiplies the resulting proportion of STJ revenue by the total amount of costs to be shared to determine the amount of shared costs to assess the STJs. In fiscal year

1995-96, the board multiplied 10.96 percent (from Table 10) by $181.6 million (from Table 9) to arrive at an STJ assessment of $19.9 million for shared costs.

The Board's Method for Allocating Costs to Individual STJs

After the board calculates the amounts of direct and shared costs to assess the STJs in total, it calculates how much of these costs each STJ will be assessed. To begin this process, the board places each STJ into one of five groups depending on two factors: whether the STJ is located in a county with another STJ (2-STJ county) or is alone in the county (1-STJ county) and on the tax rate the STJ charges. In fiscal year 1995-96, 14 STJs

Table 10

Calculation of the Percentage of Shared Cost To Be Assessed to Special Tax Jurisdictions Fiscal Year 1995-96

Line Number	Calculation Element	Amount (Dollars in Millions)
1.	Total revenue estimated to be earned from the five sales taxes	$24,931
2.	Less revenue estimated to be earned from the two half-cent taxes	3,153
3.	Subtotal #1	21,778
4.	Less revenue estimated to be earned from the STJs	2,069
5.	Subtotal #2	19,709
6.	Times percentage of dollar value of sales in counties with STJs	85.31%
7.	Subtotal #3	16,813
8.	Plus revenue estimated to be earned from the STJs	2,069
9.	Subtotal #4	18,882

10.	Proportion of STJ revenue to total revenue (line 8 divided by line 9)	10.96%

were in the 2-STJ county group that charged a tax rate of 0.5 percent, 14 STJs were in the 1-STJ county group that charged a tax rate of 0.5 percent, 2 STJs were in the 1-STJ county group that charged a tax rate of 0.25 percent, one STJ was in the 1-STJ county group that charged 0.125 percent, and one STJ was in the 1-STJ county group that charged a tax rate of 0.1 percent.

The board takes the number of STJs within a county into consideration when it performs the calculations because an STJ in a 2-STJ county shares the costs of the board's workload in that county with the other STJ whereas those STJs in 1-STJ counties incur the entire costs. The board takes the tax rates STJs charge into consideration because, if it did not, the method of cost allocation used to allocate costs to individual STJs would result in those STJs that charge higher tax rates subsidizing STJs with lower tax rates.

Once the STJs are placed in the applicable groups, the board calculates the proportion of costs each group should pay. The board calculates the proportion of both direct and shared costs each group incurs based on key indicators of workload. For example, if 54 percent of the tax returns in the State are filed by retailers in STJs that fall into the 2-STJ county group, the board will allocate 54 percent of the direct and shared costs for return processing to this group.

The board then allocates to each STJ an amount proportionate to the revenue that STJ will earn. For instance, if an STJ in the 2-STJ county group earns 37 percent of the revenue generated by the STJs in the group, the board allocates 37 percent of that group's costs to the STJ.