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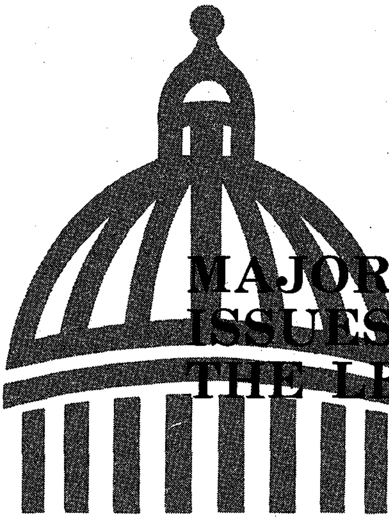
Part Three



MAJOR FISCAL ISSUES FACING THE LEGISLATURE

This part discusses some of the broader issues facing the Legislature in 1985. Many of these issues are closely linked to proposals contained in the Governor's Budget for 1985–86. Others are more long-range in nature and will, in all probability, persist for many years beyond 1985. Even in these cases, however, legislative action during 1985 is desirable because the Legislature generally will have a wider range of options for addressing these issues in 1985 than it will have in subsequent years.

We have grouped the issues discussed in this part into two major sections.

State Revenue Issues. The first section identifies issues related to state revenues. Specifically, we discuss California's use of the *unitary method* for taxing corporate profits and the potential consequences of changing from a worldwide combination approach to a water's-edge approach. We also discuss options available to the Legislature to ensure stable and adequate *funding for transportation* and the Governor's *tax expenditure* recommendations.

State Expenditure Issues. The second section identifies issues related to state expenditures. Here, we discuss the effect of the Governor's proposed *staffing reductions* on state programs and operations, the budget's proposals to expand *contracting out* for personal services, ways in which the Legislature could facilitate its review of the state's *infrastructure* needs, and the criteria that should be used to assure that state *automation* projects are soundly conceived and implemented. In this section, we also assess the state's regulation of financial services in the face of a deregulated environment, and the concept of comparable worth as a means of achieving state employment goals.

In addition to the issues discussed in this part, numerous major policy and funding issues are discussed in the *Analysis*.

Revenue Issues

CALIFORNIA'S USE OF THE UNITARY METHOD

Should the Legislature Alter the State's "Unitary" Method of Taxing Corporate Profits, and If So, How?

The most controversial tax-related policy issue facing the Legislature today involves the so-called "unitary" method of establishing the corporate tax liabilities for those firms that conduct business both in and out of California.

This section discusses what the unitary method of corporate taxation is, why it is used, what its main advantages and disadvantages are, and what the potential consequences are if the Legislature determines that the method needs to be modified or replaced.

The Basic Problem: How to Tax Multijurisdictional Corporations

The State of California imposes a tax equal to 9.6 percent of the net income earned by banks and corporations that do business in the state. The key step in computing the amount of tax that an individual firm owes is determining its "net income" which, in simple terms, is its total income minus its costs.

For those banks and corporations that do business exclusively *within* the state, "net income" can be determined in a relatively straightforward manner. Since all of their business activities occur within the state, all the income and costs associated with these business activities can be totaled up and used to compute "net income."

Properly measuring "net income" for state tax purposes is not so simple, however, in the case of firms that have business activities both *within* and *outside* of California. This is because the state's tax is intended to apply only to income earned *within* California. Thus a corporation's income must be *apportioned* according to *where* it is earned, to ensure that only California-source income will be included as "net income" for state tax purposes.

As a practical matter, however, it has proven extremely difficult for either corporations or governments to devise a method for apportioning income to the state which is capable of accurately separating income associated with a firm's in-state operations from the income associated with its out-of-state operations. This is because a business's entire spectrum of management, production, accounting, marketing, and distribution activities may be spread around the country or the world, and each activity nonetheless plays a role in determining the overall profitability of the firm. It is the contribution to the firm's overall profitability made by activities within California to which, ideally, the state's tax should apply.

Allocation Methods. "Separate accounting," which is used by the federal government to distinguish between U.S. and foreign-source income for federal income tax purposes, is one way of allocating income according to where the income is earned. Under this method, all of the transactions between a U.S. firm and its foreign business partners are evaluated to determine whether the transaction prices are reflective of the typical "market" price for such a transaction. By restating these transactions at market or "arms length" prices, it is possible to approximate the true net income of the U.S.-based company. The success of this method, however, depends heavily on the amount of effort expended in evaluating a company's transactions, and the extent to which comparable transactions exist in the marketplace. The use of sophisticated accounting techniques and transfer pricing schemes, if undetected, can allow a firm to understate its net income for the U.S.-based company.

The other method of allocating income according to where it is earned in effect *apportions* the overall income of a company in relation to the level of business activity it conducts in different locations. Thus, this method, in effect, assumes that all activities of the firm are equally profitable, and that profits are a direct function of the level of business activity. Whether the results of using any single method to apportion corporate income to, say, California are "reasonable" will depend on the particular circumstances of individual corporate taxpayers—their environment (which involves factors such as labor costs, land values, access to raw materials, and energy supplies) and their organizational structure. Thus, *no single method of apportioning corporate income to an individual state* —no matter how sophisticated—will allocate profits accurately in all cases. The "apportioning" approach is simply a "second best" solution to an inherently complex accounting problem.

An Overview of the Unitary Method

The most popular "second best" solution to the problem of apportioning income geographically is the "unitary" apportionment method. Under this approach (which is used in varying forms by all 45 states that levy taxes on, or based on, corporate income, including California), the amount of a firm's total income subject to state taxation depends on how closely the firm's in-state activities are "unitary" (that is, unified or integrated) with its operations outside the state. The "unitary" concept can be applied to the activities of a *single* corporation operating in different geographic locations. It can also be applied to the activities of a *group* of corporations, such as a parent company and its subsidiaries and affiliates, by treating all members of the group as *one* unit for tax purposes. California is one of several states that uses the "worldwide combination" method, which requires corporations doing business in California to include *foreign* parent corporations, subsidiaries, and affiliates as part of their "unitary" business.

There are three basic steps involved in using the unitary method to determine a corporation's income for purposes of taxation in California:

- *First,* the Franchise Tax Board (FTB) must determine *which corporate or intercorporate activities* are sufficiently interrelated to be included as part of the corporate taxpayer's unitary business.
- *Second,* the board must determine the *type and amount of income* that is subject to formula apportionment.
- *Third,* the board must apply an *apportionment formula* to the taxpayer's unitary business income.

Determination of Unitary Activities. The FTB's general policy is to consider business operations to be "unitary" whenever there are *any* transactions or activities between corporate divisions or subsidiaries within and outside of the state. Such transactions and activities can include purchases of materials, advertising done on a cooperative basis, and centralized purchasing, marketing, and accounting. In some cases, the flow of goods or benefits between divisions and subsidiaries may not be significant, casting doubt on the existence of a "unitary relationship". The FTB maintains, however, that a unitary relationship cannot be measured with sufficient accuracy to enable such distinctions to be made on a case by case basis, and the flow of goods or benefits must therefore be regarded as presumptive of a unitary relationship.

Income Subject to Apportionment. Only a taxpayer's income from unitary business sources is apportioned to California for purposes of taxation. Thus, FTB must separate unitary business income from nonbusiness income. The latter, which includes interest, rents, royalties, and certain dividends, is allocated entirely to the state where the corporation is domiciled, and is not apportioned among its separate locations.

Once nonbusiness income has been removed from the corporation's income, the *taxable* amount of unitary business income must then be determined on the basis of California rules for deductions, exclusions and other factors which affect a taxpayer's liability.

The Apportionment Formula. As a general rule, the FTB uses a simple arithmetic average of three factors to allocate unitary business income to California. These factors are:

- ***The Property Factor.*** This includes all real and tangible personal property owned or rented and used to produce business income.
- ***The Payroll Factor.*** This includes all wages, salaries, commissions and other compensation paid directly to employees whose services are used to produce business income, and
- ***The Sales Factor.*** This includes all gross receipts less returns and allowances, from transactions and activities in the regular course of a firm's business.

These specific factors are used both because they generally bear some relationship to a corporation's overall income-producing ability, and because they are relatively easy to measure and assign to a specific geographic area such as a state.

For each factor, the taxpayer must calculate what its *worldwide total* is—that is, total property, payroll, and sales for all of its divisions and subsidiaries within and without the state that have been designated as part of the "unitary" business. Next, the percentages of its total payroll, property, and sales *within California* are determined. The *average* of these three percentages is then applied to the taxpayer's total taxable business income in order to determine the actual amount of income attributable to California for tax purposes.

The actual apportionment percentage may range from near zero, for a corporation with only minor business interests in California, to near 100 percent for a firm that is predominantly California-based. The statewide average for "unitary" corporations was about 14 percent in 1982. That is, on average, about 14 percent of the business income earned by corporations with unitary operations both inside and outside of California was subject to state taxation.

The Current Controversy Over the Unitary Method

The use of the unitary method by states like California has been controversial for some time. There has been considerable debate, for example, over such issues as exactly how a "unitary business" should be defined and whether specific types of income, such as dividends, should be subject to formula apportionment.

The greatest controversy, however, has arisen over California's and other states' designation of income associated with *foreign operations* as unitary business income—the "worldwide combination" element of the unitary method. To some extent, the controversy is inevitable since there is little agreement on the proper way to account for the multitude of factors that come into play when domestic-source income must be combined with foreign-source income. These factors include currency fluctuations, differences among nations in how taxable income is determined, and the role of foreign taxes and tax credits.

In addition, many multinational companies have contended that the use of "worldwide combination" causes more of their income to be taxed by California than is justified, given the extent and profitability of their business activities in the state. As a result, many argue that a large number of firms, especially foreign-based multinationals, choose to locate, expand or relocate outside of California.

In response, California tax administrators generally defend the unitary method, arguing that it is the fairest, simplest, and most practical way to tax the often complex and interconnected operations of multistate and multinational corporations. They also stress that despite its limitations, the unitary method is better than letting companies use sophisticated "separate accounting" techniques to avoid paying their "fair share" of California taxes.

The federal government attempted to assist states in dealing with the controversy over the unitary taxation method by establishing a working group in 1983, composed of representatives from the federal government, state governments, and the business community. The purpose of this group was to examine the unitary method and develop options for reform. However, the group was unable to reach agreement on many significant unitary-related issues, or recommend any specific reform option that states should adopt.

What Should the Legislature Do?

The choice facing the Legislature in 1985 is *not* between retaining the unitary method and abandoning it. Rather, the choice involves what, if any, changes should be made in the state's unitary method of taxing corporations.

This is an important distinction. Often, the debate over this issue is framed in terms of being "for" or "against" the unitary method. In reality, however, the unitary approach is *not* the issue. In fact, state tax administrators and businesses alike have come to accept the unitary approach as perhaps the only viable means for dealing with the complex problem of geographically apportioning the corporate income of multijurisdictional companies with interdependent business activities.

Rather, the issue is: *how far* should the unitary method extend? Should it apply to worldwide income, as it does under California law, or should it be restricted to U.S. businesses by abandoning the worldwide combination in favor of the "water's-edge" approach?

Water's Edge Versus Worldwide Combination

Under the water's-edge method, only the income associated with domestic business activity is considered in the apportionment process. This is in contrast to the *worldwide* unitary combination method, now used by California, which makes the income associated with *all* of a corporation's unitary operations—foreign and domestic—subject to apportionment.

Table 42 shows which elements of a unitary business are subject to taxation under the worldwide combination and water's-edge methods, for both domestic and foreign-based businesses. The table shows that in the case of worldwide combination, *all* multinational corporations—domestic and foreign—must include income and apportionment factors from parent corporations, subsidiaries operating in the U.S., and subsidiaries in other countries in determining their tax liabilities. In contrast, under the water's-edge approach, *foreign-based corporations* would only have to recognize income earned by their subsidiaries operating within the U.S. and include their apportionment factors. Transactions between domestic and foreign subsidiaries of a unitary corporation would have to be restated at market prices in order to determine the domestic subsidiaries' income, but the profits of the foreign subsidiaries would be ignored. Under the water's-edge approach, *domestic corporations* would continue to include domestic parents or subsidiaries, but would, in general, separately account for the activities of foreign subsidiaries.

Table 42
Apportionment Factors And Income Subject to Taxation Under The Unitary Method Water's Edge versus Worldwide Combination

Domestic-Based Corporations

Worldwide Combination	*Water's Edge*	
Factors and Income from the following units are combined:	Factors and Income from the following units:	
	Combined:	Not Combined
Domestic Parent	Domestic Parent	Foreign Subsidiaries
Domestic Subsidiaries	Domestic Subsidiaries	
Foreign Subsidiaries		

Foreign-Based Corporations

Worldwide Combination	*Water's Edge*	
Factors and Income from the following units are combined:	Factors and Income from the following units:	
	Combined:	Not Combined:
Domestic Subsidiaries	Domestic Subsidiaries	Foreign Parent
Foreign Parent		Foreign Subsidiaries
Foreign Subsidiaries		

If the Legislature were to adopt the water's-edge approach in place of worldwide combination, it still would be faced with a number of difficult implementation problems that could easily be as controversial as the worldwide combination approach has been. These problems have to do with what types of foreign-source business income should continue to be subject to apportionment for tax purposes. The two most important of these issues relate to the treatment of foreign dividends and "80/20" corporations.

1. Foreign Dividends

The water's-edge approach attempts to distinguish between a unitary business's domestic and foreign operations. There often are situations, however, where the domestic and foreign operations are closely related. For example, a domestic manufacturer may rely on a foreign-based sales subsidiary to sell its products in other countries. In such cases, the income from the foreign subsidiary normally comes back to the U.S. parent company in the form of *dividends*. An important issue for the Legislature to decide is whether such dividends should be treated as U.S. or foreign-source income.

Under worldwide combination, the treatment of dividends paid between members of a business family is not an important issue. This is because the worldwide combination method looks at the *total* income from all of the unitary family's businesses. Therefore, it does not matter whether a foreign subsidiary pays dividends to its domestic parent or keeps its income as retained earnings. In either situation, the income would still be reported for state tax purposes.

Under the water's-edge approach, the treatment of foreign-source dividends for apportionment purposes is a major issue. On the one hand, it can be argued that the treatment of such dividends as unitary business income is justified to the extent that the income which these dividends represent was derived from activities which constitute an integral part of the unitary business. This might be the case, for example, where the dividend paying foreign subsidiary sells raw materials to its domestic parent for use in manufacturing products within the United States.

On the other hand, a number of significant arguments can be raised against the treatment of foreign dividends as apportionable business income. The federal government and many states *exclude* dividends, including foreign dividends, paid to corporations on the basis that dividends are derived from income that already has been taxed in another jurisdiction. Moreover, including foreign dividends in apportionable income could work at "cross-purposes" to the objective of replacing the worldwide combination with the water's-edge approach. This is because, if dividends are included, it may be necessary for corporations to first "apportion" the dividend income between the U.S. and the foreign operation in much the same way as the net income of the foreign corporation is apportioned at present. Since the underlying purpose of the water's-edge approach is to account for *foreign* activities separately, a policy of taxing dividends paid by a foreign corporation from foreign earnings could be regarded as inconsistent with the new approach.

2. 80/20 Corporations

The treatment of "80/20" corporations under a water's-edge approach raises similar issues. The so-called "80/20" corporations either have at least 80 percent of their payroll and property outside the U.S. or receive at least 80 percent of their income from foreign sources.

Although incorporated within the U.S., such corporations conduct a substantial amount of business activity in other countries. On this basis, it often is argued that they are essentially foreign corporations, and thus, all of their income should be regarded as foreign-source income not subject to taxation by the state. On the other hand, a strong case could be made for including 80/20 corporations within the water's-edge, on the basis that they are managed in the U.S., they have some business activity in the U.S., and are incorporated in the U.S. to take advantage of beneficial federal tax laws.

If the Legislature chose to include 80/20 corporations within the water's edge, the business income of the 80/20 corporations would have to be apportioned between domestic and foreign sources. Thus, the state would find itself with some of the same problems that it hoped to avoid by abandoning worldwide combination.

What Factors Should the Legislature Consider in Deciding Whether to Modify the Unitary Method of Taxing Corporations?

We believe the Legislature should give consideration to four basic questions in deciding whether to retain the worldwide combination approach to unitary taxation or to adopt the water's-edge approach. These questions are identified and discussed below.

1. How Would Changes in the Unitary Method Affect Different Taxpayers? Changing the current method of apportioning income could have significantly different effects on different taxpayers. Some would benefit from the the change; others might be unaffected; and still others might find themselves paying higher taxes. The effects of the change on an individual corporation would depend on a variety of factors, of which three stand out: (a) the relative profitability of the firm's domestic and foreign operations, (b) whether a firm is foreign or domestically-based, and (c) how the firm is organized.

a. Relative Profitability of Domestic and Foreign Business Activities. Under the current method used by California to determine a unitary corporation's taxable income, the FTB *combines* the total worldwide business income of the corporation, and then uses the formula apportionment method to assign a share of this income to the state. This method, in effect, ignores differences in the profitabilty of the firm's various activities, because business income from *all* unitary activities—regardless of location—is combined for state tax purposes.

The water's-edge approach makes a clear differentiation between domestic and foreign operations. Thus, any differences in the profitability between domestic and foreign operations would be reflected in the amount of income assignable to California. Consequently, those businesses with more profitable foreign operations would pay *less* in bank and corporation taxes under the water's-edge approach than under worldwide combination.

Some businesses, however, would find themselves in just the opposite situation. These businesses would be unable to factor in their relatively unprofitable foreign operations in computing their total income for tax purposes in California, and would end up with larger state tax liabilities. It is possible, however, that such businesses still could continue to file on a worldwide combination basis, even if the state abandoned this approach in favor of water's-edge. Recently, the U.S. Supreme Court let stand a decision by the Illinois Supreme Court which held that a multinational corporation could use the *worldwide combination method* to account for operations outside of the state, even though the state allowed only the water's-edge method of recognizing income to be used. Thus, even if the Legislature repealed worldwide combination, the state potentially could find itself without the power to enforce a ban on worldwide combination.

b. Foreign-Based Versus Domestic Multinational Corporations. Current state law treats foreign-based and domestic-based multinational corporations the same—both must combine their worldwide business income in determining the amount of income subject to state tax. The water's-edge approach, however, could provide foreign and certain domestic multinationals with very different levels of tax relief, depending on how income from foreign operations is treated.

Consider, for example, the Governor's 1984 unitary reform proposal. This proposal would have moved California from the worldwide combination approach to a modified water's-edge approach. If it had been enacted, companies *electing* to file under the water's edge would have been required to include in domestic income the *apportioned* earnings of so-called "80/20" corporations, as well as certain foreign-source dividends. As a result, the reduction in taxes for domestic-based multinationals would have been, on average, about 5 percent. In contrast, foreign-based multinationals, which would not have been required to report income from non-U.S. business operations, would have realized a reduction in taxes averaging 25 percent.

In sum, *domestic* multinationals may *not* see any significant tax relief under the water's-edge approach, particularly in comparison with foreign multinationals, unless income from 80/20 corporations and dividends from foreign activities are treated as foreign-source income. If domestic firms are not able to exclude *non-U.S.* income, it could put them at a competitive *disadvantage,* relative to their foreign-based competitors, because their overall tax liability would be greater.

c. Organization of Unitary Business. Some domestic-based multinational corporations conduct their foreign activities through 80/20 corporations incorporated in the U.S. This allows them to take advantage of U.S. tax benefits and provides them with copyright, patent, and other protections under foreign-trade treaties. Other domestic multinationals find it advantageous to conduct their foreign activities through controlled foreign corporations (CFCs) incorporated outside the U.S. This allows them to defer paying taxes on foreign income until dividends are repatriated to the United States.

If a water's-edge unitary approach is adopted that includes the apportioned earnings of 80/20 corporations in the taxable base, domestic multinationals using CFCs would be better off than those using 80/20 corporations, solely because of where their subsidiary is incorporated.

2. How Would the Proposed Change Affect Business Investment and Overall Economic Activity in California? Critics of the unitary method argue that it represents a significant barrier to business investment in California by multijurisdictional corporations because such investment immediately subjects income earned outside of California to the state's bank and corporation tax. In some cases, new investment in California can increase the corporation's total tax bill, even though the investment itself has *not* generated *any* net income. Some foreign multinational corporations, particularly those from Japan, claim that they will restrict their investments in California for this very reason.

It is not surprising that multinational corporations make this threat. Clearly, a water's-edge or separate accounting approach would enable them to reduce their taxes, so that it is in their financial interest to "knock" the worldwide combination approach to unitary taxation. The key question, then, is: to what extent does the California unitary tax actually discourage investment in the state?

There is no substantive data that we know of which conclusively demonstrates that California's unitary approach has had a significant negative effect on the overall level of business investment in California. In fact a variety of economic and business indicators, taken together, tend to show that California continues to be an attractive place for business to expand or locate, notwithstanding the state's worldwide unitary approach to taxation. The available data indicate that California leads the nation in direct foreign investments and has far more new plants and plant expansions underway than any other state.

From an analytical standpoint, the unitary approach, by itself, should *not* have a particularly significant effect on the level of economic activity in California. This is because (1) state taxes are but one of many considerations facing firms planning to locate or relocate their operations, and (2) state taxes constitute a fairly small share of total business costs, and the bank and corporation tax is but one of many different state and local taxes levied.

Nevertheless, it is clear that California's current worldwide combination approach to taxation can have a negative impact on decisions by some businesses to locate or expand in the state, particularly if these businesses are foreign-based. Where this is true, the water's-edge method, by allowing a corporation's foreign source income to be excluded from the apportionment process, could make investments by multinationals in California more attractive.

For domestic-based multinationals, the impact on business investment of changes in the unitary method of taxing corporate income is less obvious. If income from foreign dividends and 80/20 corporations were *excluded,* thus providing domestic multinationals with significant tax relief, some firms could find investments in the state more attractive. At the same time, however, others could find it more attractive to invest in *foreign countries* rather than in California or other parts of the U.S. Since foreign income would not be subject to the apportionment process, some companies may find it attractive to shift operations to low tax foreign countries or tax havens, and thereby not be required to apportion the income to California. If, in contrast, income from foreign dividends and 80/20 corporations is not excluded from taxation, a move from the worldwide combination approach to water's edge probably will have little effect on investment incentives for domestic multinationals.

*3. **How Would Changes in the Unitary Method Affect State Revenues?*** Corporations subject to the unitary method account for over 75 percent of California's total corporate tax base. Thus, any changes in how the net income of these corporations is defined and apportioned to California can have a significant effect on state revenues. The FTB has estimated that a shift from worldwide unitary apportionment to a strict water's-edge unitary apportionment approach with *all* foreign income excluded, could result in a net annual General Fund revenue loss of $340 million. This revenue loss reflects reduced taxes of $560 million for one group of taxpayers and increased taxes of $220 million for another group. In evaluating FTB's estimates, the Legislature should keep in mind that the potential General Fund revenue loss could end up being $560 million, rather than $340 million. This is because, as noted above, the state may *not* be able to require all corporations to file on a water's-edge basis. If this turned out to be the case, the state would be unable to collect all or part of the $220 million in *increased* taxes resulting from the water's-edge approach, because companies which presently benefit from worldwide combination could still file on that basis, regardless of state law.

*4. **How Would Changes to the Unitary Method Affect Tax Administration?*** One key question for the Legislature to consider is whether a change from California's current worldwide unitary method to some alternative method would make it more difficult and costly for FTB to administer and enforce state tax laws. We believe that it *would.* This is because a change from worldwide combination would necessitate the use of separate accounting by corporations. For example, if a water's-edge approach were adopted, it would be crucial for FTB to conduct in-depth audits of income and expense transactions between domestic and foreign affiliates, including intercompany transfers and pricing arrangements which, if unchecked, could be manipulated to reduce income reported for U.S. tax purposes.

A recent report by the General Accounting Office concluded that the complexities of separate accounting impose considerable burdens on tax collectors and corporate taxpayers alike. The FTB has estimated that its increased audit costs under a water's-edge approach would be in the range of several million dollars per year. There would be some offset to these costs to the extent FTB received audit information, auditor training help, and other types of assistance from the federal government, which also audits multinational corporations. Even so, however, state tax administration costs would increase. These costs would show up either as a direct increase in the cost of audit activities, or as a reduction in audit revenues because FTB had to redirect resources from other audit areas to fund the separate accounting audits.

Conclusion

Clearly, the issues surrounding the debate over the unitary method of taxation pose a formidable challenge to the Legislature. What makes the issues particularly intractable is that no one, including tax administrators, accountants, auditors, and professional economists, knows the "right" way to resolve them.

Based on our review of these issues, we conclude that:

1. The Legislature should not abandon the current unitary method of worldwide combination. There is no solid evidence that worldwide combination has significantly reduced investments in California. Nor is there any evidence to support the belief that abandoning this method would result in a substantial *net* increase in economic activity within California. Furthermore, we believe that the alternative to worldwide combination—separate accounting—is likely to give multinational firms too many opportunities to avoid paying their fair share of California taxes. Thus, the state could easily experience significant losses of revenue from tax evasion over and above the $560 million revenue loss that could result if taxpayers were allowed to file their business and corporate tax returns on a water's-edge basis.

2. If the Legislature adopts the water's-edge approach, it should exclude from taxable income all income derived from 80/20 corporations and foreign dividends.

We recognize that the Legislature is faced with demands from many quarters to replace the worldwide-combination approach with the water's-edge approach. If it chooses to allow taxpayers to file their returns based on the water's-edge approach, it will have to resolve the difficult issue of how foreign-source income from 80/20 corporations and foreign dividends should be treated for California tax purposes.

In resolving this issue, we believe the Legislature should be guided by the principle that state tax policy should not discriminate in favor of either U.S. or foreign firms. In our view, the only way to achieve this objective is to *exclude* from taxable income, the income received from 80/20 corporations and foreign dividends.

If domestic multinationals are required to count this income in determining their California tax liabilities, they would be put at a competitive disadvantage, relative to foreign-based multinationals. This is because foreign-based multinationals would be allowed to *exclude* income from their non-U.S. operations, giving them a lower tax bill (other things being equal). This, in turn, might allow them to hold prices below their domestic counterparts, without having to sacrifice profits.

Moreover, if the Legislature required firms to include income from foreign dividends and 80/20 corporations in their taxable income, the need to consider foreign factors to *apportion* the income would continue. This would sacrifice some of the benefits anticipated from replacing worldwide combination with water's edge.

Thus, from a tax policy standpoint, we conclude that the water's-edge method would only make sense if income from foreign dividends and 80/20 corporations were excluded from the apportionment process. This option, however, carries a heavier price tag relative to water's edge with foreign income included.

3. If the Legislature chooses to retain the worldwide combination approach, it should direct the Franchise Tax Board to investigate alternatives to improve the apportionment of income.

The current method used to apportion income is not precise. In some cases, taxpayers probably are required to pay more than their fair share of California taxes. There also are numerous unresolved issues that should be addressed, such as how a "unitary business" ought to be defined, what kinds of income should be subject to apportionment, and what specific factors are appropriate for use in the apportionment formula.

These issues could be resolved through "fine tuning" the current method used to apportion income. For example, the FTB could allow businesses greater flexibility in the use of factors other than payroll, property, and sales, or in how these factors are weighted for apportionment purposes, in cases where this would improve the apportionment of income from an economic standpoint. We believe the Legislature should direct the board to explore the possibilities for fine tuning, if it decides to retain the worldwide combination approach.

TRANSPORTATION FUNDING

Will the Amount Available to Fund the State's Transportation Programs and Related Safety and Law Enforcement Activities be Adequate in the Years Ahead? What Options Are Available to the Legislature to Ensure Stable and Adequate Funding for These Programs and Activities?

California finances its transportation program and related activities with a combination of federal, state and local funds. These monies pay for the construction and maintenance of state highways and local streets and roads, the operation of and capital improvements to mass transportation systems, and the licensing and regulation of vehicular traffic. In general, funds are derived from a range of "user fees" that motorists and transit passengers are charged for the privilege of using the state's transportation network.

As we discussed in Part Two of this document, there is a significant imbalance between the fiscal health of the state's General Fund and that of many special funds. While General Fund revenues are expected to grow rapidly in the current and budget years, special fund revenues are not growing, and in some cases they are shrinking. This is particularly true with regard to those special funds that support transportation programs in California. Projections of state transportation fund balances during the period 1985–86 through 1989–90 indicate that the three major transportation accounts collectively are facing a potential shortfall relative to planned expenditures in excess of $1 billion. The Governor's Budget does not indicate whether the administration will seek revenue-raising legislation to resolve this problem, or seek to reduce services provided under these programs. One way or another, however, the Legislature will have to deal with this potential shortfall in the near future.

This section analyzes the condition of state transportation funding and identifies the options available to the Legislature to ensure a stable and adequate funding source for transportation programs and activities in the future.

Transportation Accounts Face Potential Shortfalls

Revenues derived from user fees charged to motorists are deposited in three separate accounts—the State Highway Account (SHA), the Transportation Planning and Development (TP and D) Account, and the Motor Vehicle Account (MVA). Together, these three accounts provide over 99 percent of state funding for transportation-related activities.

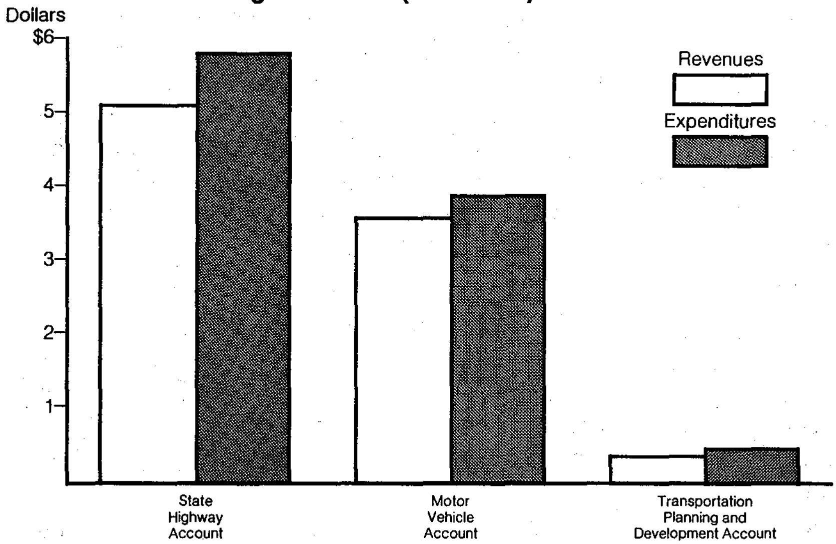
Our review of the condition of the three accounts shows a total shortfall of resources relative to expenditures over the five-year period of over $1 billion. These shortfalls will materialize at different times, as follows:

- *State Highway Account*—the shortfall will begin in 1987–88, and will likely be less than the $763 million currently projected.
- *Transportation Planning and Development Account*—the shortfall will begin in 1985–86 and reach $109 million for the five years combined. The administration proposes to cancel or postpone $34.7 million in previous local transit capital expenditure commitments in 1985–86 to keep the account in balance for the budget year.

- ***Motor Vehicle Account***—the shortfall will begin in 1987–88, and reach up to $327 million by 1989–90.

These shortfalls are illustrated in Chart 18.

Chart 18
State Transportation Program Cumulative Funding Condition [a]
1985–86 through 1989–90 (in billions)



[a] Sources: State Transportation Improvement Program (STIP) fund estimate. Secretary for Business, Transportation and Housing. Includes Legislative Analyst Office's estimate for the Motor Vehicle Account for 1989–90.

Table 43
State Transportation Program Fund Condition [a]
1985–86 through 1989–90
(dollars in millions)

	Total Resources All Funding Sources	*Expenditures*			*Fund Balances in June 1990*
		Support and Local Assistance	*Capital Outlay*	*Total*	
State Highway Account	$5,086	$4,680	$1,169 [b]	$5,849	−$763
Transportation Planning and Development Account	392	392	109	501	−109
Motor Vehicle Account [c]	3,582 [d]	3,845 [e]	64	3,909	−327
Totals	$9,060	$8,917	$1,342	$10,259	−$1,199

[a] Source: 1985 State Transportation Improvement Program (STIP) Fund Estimate, unless otherwise noted.
[b] Includes $719 million to match federal funds.
[c] Preliminary projections, for 1985–86 through 1988–89 only, based on estimates by the Secretary for Business, Transportation and Housing. For the four years, a total shortfall of $191 million is projected. We have extended the projections through 1989–90.
[d] Revenue projections do not include revenues from an extension of $1 vehicle registration surcharge, but include (1) $50 million to reflect revenues from legislation enacted in 1984, and (2) a carry-in balance which is $21 million higher than that projected by the Secretary to adjust for a lower transfer to the SHA.
[e] Includes support of the AB 202 program by the MVA from 1986–87 through 1989–90.

Table 43 shows the projected resources and expenditures of the three accounts from 1985–86 through 1989–90. Based on current assumptions regarding pertinent economic factors and the availability of federal funds, *the state will not have sufficient funds to maintain existing levels of operating support, local assistance and capital outlay expenditures for its transportation activities beyond the budget year.*

Because of the projected shortfall for the SHA and the TP and D Account, resources will not be adequate to fund all programmed highway and mass transit expenditures and previous commitments made by the California Transportation Commission (CTC) in the State Transportation Improvement Program (STIP). Similarly, shortfalls in the MVA will necessitate program reductions in the California Highway Patrol's traffic law enforcement programs and the Department of Motor Vehicles' vehicle registration and drivers' licensing programs.

Our analysis of the condition of each of the accounts follows.

State Highway Account (SHA). The main revenue source to the SHA is the 9 cents per gallon excise tax on fuel (gasoline and diesel) used by motor vehicles. Approximately 49 percent of these revenues are apportioned to local governments for use on local streets and roads. The SHA also receives truck weight fees, which account for approximately 30 percent of account revenues.

Activities funded by the SHA include (1) construction, maintenance, and rehabilitation of the state highway system, (2) matching of federal highway assistance funds, (3) operation of the Department of Transportation, and (4) construction and improvement of public mass transit guideways.

The Department of Transportation projects a potential shortfall in the SHA of $763 million by the end of the five-year period, with the shortfall first emerging in 1986–87. Because current state law requires that (1) state funds must first be used to match all available federal funds and (2) sufficient monies must then be set aside for the operation, maintenance and rehabilitation of the state highway system, our analysis indicates that *the potential shortfall probably will result in the elimination of funding for transit guideway projects and state-financed highway capital outlay projects.* The elimination of these two expenditure categories, however, will still leave a funding shortfall of $313 million, requiring further reductions in other highway expenditures, such as highway maintenance and the design and engineering of highway capital outlay projects.

Our review indicates that the five-year shortfall will likely be less than projected by the department. This is primarily due to the difficulty in predicting account expenditures with any certainty. The department's expenditure estimate assumes that the maximum amount of federal funds will be available. However, based on past experience and current efforts to reduce the size of the federal deficit, the amount the state will actually receive over the five-year period is likely to be less-than-projected, necessitating less state matching funds. Thus, depending on the amount of federal funds available, the magnitude of the shortfall could vary considerably from the $763 million estimate. To the extent that expenditure projections for the first two years of the STIP are reduced, the first occurrence of the shortfall could be delayed one year—to 1987–88.

Transportation Planning and Development (TP and D) Account. The TP and D Account depends primarily on the retail sales tax on gasoline for its revenues. Nearly all TP and D Account funds are expended on the following three programs: (1) operation of public mass transit systems by local transportation agencies (known as the State Transportation Assistance (STA) program), (2) the state's mass transportation program which includes local transit capital assistance, and (3) the transportation planning program in the Department of Transportation.

Retail sales tax transfers to the TP and D Account are determined by a formula using three variables—the level of retail sales, the level of gasoline consumption and the level of gasoline prices. Even small changes in any one of these variables can bring about a large change in the amount transferred to the account. Of the three variables, gasoline prices are potentially the most volatile and difficult to predict. Using alternative gasoline price assumptions, Table 44 shows the impact that either lower- or higher-than-expected gasoline prices would have on projected revenue transfers during the five-year period. While higher gasoline prices would increase revenue to the account, STA expenditures would also increase automatically. Therefore, increased revenues from higher gasoline prices are unlikely to eliminate the shortfall in the TP and D Account. To the extent that gasoline prices are lower-than-projected by the five-year estimate, the funding shortfall will be more pronounced. (The uncertainty of state funding levels takes on an even greater significance given recent federal proposals to reduce or eliminate federal transit capital and operating assistance.)

Programmatically, the shortfall would require postponement or cancellation of previous state funding commitments to local transit capital outlay projects such as Los Angeles Metro Rail, Santa Clara light rail, or the improvements to San Francisco Muni. Additionally, declining TP and D revenues would reduce transit operating assistance (STA) thereby requiring local transit operators to reduce services, increase fares, or secure additional local funding. This could have a particularly severe effect upon operators, such as Alameda-Contra Costa (AC) Transit, which have a limited local funding base.

Table 44
Transportation Planning and Development Account
Sales Tax Revenue Transfers
1985–86 through 1989–90

Revenue Transfers (dollars in millions)	*1985–86*	*1986–87*	*1987–88*	*1988–89*	*1989–90*	*Totals*
Five-year estimate	$109.3	$73.6	$59.9	$42.2	$19.9	$304.9
Low gas price	76.9	31.5	0.1	—	—	108.5
High gas price	136.7	118.9	101.2	83.7	66.5	506.9
Gas Price Assumptions: (dollar per gallon)						
Five-year estimate	$1.170	$1.215	$1.306	$1.404	$1.508	
Low [a]	1.112	1.139	1.197	1.278	1.335	
High [a]	1.219	1.297	1.381	1.480	1.594	

[a] Source: Chase Econometrics.

Motor Vehicle Account (MVA). The primary revenue sources to the MVA are (1) motor vehicle registration fees, (2) driver's license fees, and (3) collection costs for motor vehicle weight fees. The majority of these revenues (90 percent in 1984–85) support the activities of the California Highway Patrol (CHP) and the Department of Motor Vehicles (DMV).

Our review shows that because of a smaller transfer to the SHA—$29 million instead of the $50 million originally anticipated—there will be an additional $21 million available to the account at the beginning of 1985–86. Consequently, the shortfall will be delayed into 1987–88, and will be approximately $327 million over the five-year period. This shortfall will likely result in (1) a reduction of CHP traffic officers in the field, and (2) longer customer waiting times at DMV offices due to personnel reductions.

Causes of Potential Funding Shortfall

Several factors contribute to the funding shortfall projected in the state's principal sources of support for transportation programs. The most important of these are as follows:

1. The traditional measures of highway usage no longer accurately reflect the demands placed on the state's transportation system. In the past, changes in gasoline consumption have been used as the measure of changes in highway usage. As a result, the highway financing mechanism is based on the consumption of fuel. Because of the increasing fuel efficiency of motor vehicles in the state, however, changes in gasoline consumption *understate* the change in total vehicle miles travelled by the public. Thus, revenues to the State Highway Account have not kept pace with highway usage.

2. The structure of excise taxes and fees does not produce the revenues needed to compensate for the effect of inflation on the costs incurred in maintaining and expanding the state's transportation system. This is because the revenue sources that the state relies on to finance transportation programs—the fuel tax, weight fees, and registration and license fees—are fixed in dollar terms. As a result, inflation reduces the purchasing power of these tax and fee rates.

3. Revenue generation is not closely linked to funding needs. Because the bulk of the state's highway system was constructed about 20 years ago, many road segments are now or soon will be in need of major repairs and rehabilitation in order to maintain their serviceability. Revenues, however, do not recognize and respond to this aging of the state's transportation network.

4. Revenues to the TP and D Account are unstable, and are affected by nontransportation factors. While TP and D Account revenues also are based on *gasoline* sales, the account's funding mechanism, in effect, gives the General Fund the first call on these revenues. Revenues from the sales tax on gasoline are used to compensate the General Fund for the retail sales tax revenues that are shifted annually to local governments (under the Transportation Development Act (TDA) to fund local transportation activities), before any of these revenues are made available to the TP and D Account. Since the size of the payback to the General Fund depends upon nontransportation factors, namely, the level of nongasoline retail sales, growth in these sales reduces the funds available to the TP and D Account.

During the period 1979–80 through 1983–84, the sales tax on gasoline generated sufficient funds to repay the General Fund *and* support transportation program activities. Beginning in the current year, the combination of nongasoline retail sales growth, and lower gasoline prices will result in significantly less revenues flowing to the account. This trend is expected to continue through 1989–90.

Options For Eliminating the Shortfall in Transportation Funds

Given the prospect of transportation funding shortfalls exceeding $1 billion during the next five years, the Legislature must either reduce expenditures below current levels or increase revenues above projected levels. Potential options for addressing the shortfalls are discussed in more detail below.

Options for Reducing Transportation Expenditures

We have identified several alternatives which would enable the Legislature to reduce expenditures in each transportation account so as to avoid a funding shortfall.

1. Reduce SHA Expenditures by up to $763 Million. To avoid a shortfall and meet statutory requirements regarding account allocations, the CTC would have to eliminate $250 million in commitments for local transit guideways, and $200 million for state-funded highway projects. This would still leave a deficit, however, of over $300 million for the five-year period. In order to balance the account, our analysis indicates that expenditures on capital outlay project design and engineering, or the use of state funds to match federal funds for highway projects, or highway maintenance activities also would have to be trimmed.

2. Reduce TP and D Account Expenditures by $109 Million. In order to balance this account, the Legislature could direct the CTC to cancel or postpone all previous funding commitments ($109 million) under the transit capital improvement program. Alternatively, the shortfall could be partially offset by discontinuing rail operating subsidies ($73 million). Operating assistance to local transit operators under the STA program ($183 million) also could be reduced or eliminated to keep the account in balance.

3. Reduce MVA Expenditures by up to $327 Million. Because more than 70 percent of the California Highway Patrol's and Department of Motor Vehicles' total expenditures are for staffing services, personnel in both departments would have to be reduced in order to offset the shortfall. For the CHP, this would almost certainly mean fewer traffic officers in the field; for the DMV, it would mean a reduction in field office personnel handling registration and licensing work, resulting in longer waiting times for the public. In addition, the CHP's expenditures for airplane and helicopter operations might have to be reduced. Alternatively, capital outlay expenditures for the construction of new CHP and DMV field offices could be deleted in order to minimize the shortfall.

Options for Increasing Transportation Revenues

Transportation facilities do not directly benefit all Californians equally. Those who depend more heavily on these facilities benefit from them to a greater extent than those who "only drive their car on Sundays." For this reason, construction and maintenance of these facilities traditionally have been funded through "user charges" that seek to link the amount of support provided with the amount of benefits derived.

The Legislature recently reaffirmed this approach to financing transportation programs. In enacting Ch 541/81, it declared that the state should rely on user charges to finance transportation facilities, and that these user charges should be adjusted as necessary to maintain services at adequate levels.

We have identified four options for increasing transportation funding that are consistent with the user charge principle. Table 45 summarizes the potential revenue impact of each option, assuming it was implemented in 1985–86.

Table 45
Transportation Funding
Potential Revenue Generated by Various Options
1985–86 through 1989–90
(dollars in millions)

Options	*Additional Revenue Over 5 Years*	*Account*
1. Indexing		
a. fuel tax [a]	$154	State Highway Account
b. truck weight fees [a]	94	State Highway Account
2. One-time increases		
a. fuel tax: +1¢ [b]	308	State Highway Account
b. truck weight fees: +10%	164	State Highway Account
c. vehicle registration fee: +$1	100	Motor Vehicle Account
3. Increase sales tax on gasoline by 1 percent	532	Transportation Planning and Development Account
	12	State Highway Account
	544	
4. Restructure TP and D funding mechanism		Transportation Planning and Development Account
a. Option A [c]	274	
b. Option B [d]	277	

[a] 1985–86 tax rates are used as base rates. An additional $148 million would be available for local streets and roads if fuel taxes are indexed.
[b] An additional $293 million would be available to local streets and roads.
[c] This does not include an additional $62 million in combined STA and TDA local assistance.
[d] This does not include an additional $86 million in combined STA and TDA local assistance.

1. Index Fuel Tax and Various Fees, Based on Changes in Transportation Costs. One option to ensure that revenues grow in step with the cost of maintaining the state's transportation system is to build into the user charge structure an automatic adjustment that reflects changing costs. For instance, the fuel tax and truck weight fees could be linked to increases in the cost of building and maintaining the highway system. Vehicle registration fees could be tied to the cost of providing traffic regulatory services. Using the same inflation assumptions used in projecting highway capital outlay expenditures, we estimate that an "indexed" fuel tax would increase fuel tax revenues to the SHA by approximately $154 million between 1986–87 and 1989–90. In addition, local governments would receive approximately $148 million more for streets and roads, thereby meeting some of the unfunded maintenance that is estimated at $840 million annually. In the same period, revenues from truck weight fees would be $94 million higher.

2. Close Funding Gap Through a One-Time Increase in the Fuel Tax and Other Fees. Alternatively, the Legislature could adjust fuel tax and other fees by an amount needed to ensure an adequate level of funding for just the next five years. We estimate that an increase of 1 cent per gallon in the fuel tax, effective in 1985–86, would increase revenues to the SHA by approximately $308 million over the five-year period. Therefore, a 2½ cent per gallon fuel tax increase would be needed to avoid a SHA shortfall of $763 million. Local streets and roads also would receive an additional $293 million for every 1 cent per gallon increase in the fuel tax.

A one-time 10 percent increase in truck weight fees in all rate categories would generate $164 million from 1985–86 through 1989–90. Similarly, an increase of $1 per vehicle registration, beginning in 1985–86, would increase revenues to the Motor Vehicle Account by $100 million ($20 million annually). Thus, more than a $3 increase per vehicle registration would be necessary to avoid a MVA shortfall over the five-year period.

3. Increase the State's Retail Sales Tax Rate on Gasoline to Augment TP and D Account Funding. A one percent increase in the retail sales tax rate on gasoline (from 4.75 percent to 5.75 percent), everything else being equal, would generate additional revenues over the five-year period of approximately $532 million and $12 million to the TP and D Account and the SHA, respectively. (These estimates make no allowance for any reductions in gasoline consumption which might result from the sales tax increase.)

While this option would augment funding for the TP and D Account, it would not address the instability inherent in the TP and D funding formula.

4. Restructure TP and D Account Funding so that Account Revenues Depend Directly on Gasoline Retail Sales Tax Revenues. Financing the TP and D Account *directly* from gasoline retail sales tax revenues would eliminate revenue fluctuations caused by changes in non-transportation-related factors, and produce a more stable source of funds to the account. Table 46 summarizes the revenue impact of two options for accomplishing this.

Both alternatives would:

(a) Discontinue shifting a portion of retail sales tax revenues to local agencies for transportation activities (this raises the state's share of the 6 percent sales tax from 4.75 percent to 5 percent);

(b) Apportion revenues derived from the higher 5 percent rate on *gasoline* between local transportation funding (TDA) and the TP and D Account; and

(c) Make no change in the allocation of the TP and D Account in support of local transit operations (the current STA program).

Table 46
Revenue Impact
for Various TP and D Funding Options
1985–86 through 1989–90
(dollars in millions)

Current Law	*1985–86*	*1986–87*	*1987–88*	*1988–89*	*1989–90*	*Totals*[a]
(4.75% state gasoline sales tax)						
Local Share[b]	$611	$642	$693	$748	$810	$3,502
State TP and D	44	29	24	17	8	122
Option A						
(5% state gasoline and diesel sales tax)						
Local Share[b]	$646	$662	$706	$751	$799	$3,564
State TP and D	72	74	78	83	89	396
State General Fund	−63	−65	−67	−69	−72	−336
Option B						
(5.5% state gasoline sales tax)						
Local Share[b]	$648	$665	$710	$757	$809	$3,588
State TP and D	72	74	79	84	90	399
State General Fund	—	—	—	—	—	—

[a] Details may not add to totals due to rounding.
[b] Includes 75 percent apportionment to locals for TDA activities, and 60 percent of TP and D sales tax revenues for STA purposes.

Option A would expand the tax base to include gasoline *and diesel* fuel. Currently, revenues from the sales tax on diesel fuel are transferred into the General Fund. Consistent with the "user charge" principle, Option A would dedicate these revenues to transportation-related purposes. This option would reduce General Fund revenues by approximately $336 million over the five-year period, while increasing revenues for mass transportation programs by a corresponding amount including *$62 million more* for the local share of *combined* TDA and STA funds, and *$274 million more* for the state's share of TP and D Account funds.

Option B would retain the current (gasoline only) tax base but would increase the state's retail sales tax rate on gasoline to 5.5 percent. Over the next five years, this option would bring about a net increase of $86 million in the local share of retail sales tax revenues, while the state's share of TP and D Account funds would increase by $277 million. The state's General Fund would not be affected by this option.

Increased Resources Will Be Needed

We recommend the enactment of legislation to:

1. ***Link future increases in motor vehicle fuel tax rates and truck weight fees to increases in the cost of building and maintaining the highway system,***
2. ***Link future increases in vehicle registration fees to the cost of providing traffic regulatory services, and***
3. ***Raise motor vehicle fuel tax, truck weight fees and registration fees to increase transportation funds prior to 1987–88.***

Based on our review of the State Highway Account and the Motor Vehicle Account shortfalls, we conclude that, in order to ensure an adequate source of funding for transportation facilities and services, the state's user charge system should be restructured so that account revenues are more closely linked to the cost of maintaining transportation facilities and services. Accordingly, we recommend the enactment of legislation to (1) link future increases in motor vehicle fuel tax rates and truck weight fees to increases in the cost of building and maintaining the highway system, and (2) link the increases in vehicle registration fees to increases in the cost of providing traffic regulatory services.

In addition to ensuring future revenue increases commensurate with the increase in costs of transportation facilities and services, our analysis indicates that there is also a need to close the existing funding gap by 1987–88, *if the current level of services and expenditures are to continue.* This would necessitate an increase in the fuel tax and other fees. Accordingly, we recommend the enactment of legislation to raise motor vehicle fuel tax, truck weight fees, and vehicle registration fees to increase transportation funds prior to 1987–88.

Funding Mechanism Should Be Changed

We recommend that legislation be enacted to restructure the funding of the Transportation Planning and Development Account, and to extend the gasoline sales tax to diesel fuel.

Our review of the Transportation Planning and Development Account's current and projected condition indicates the need for legislative action. The instability generated by the existing funding formula creates too much uncertainty for transit operators, local transportation planning agencies and the California Transportation Commission, thus impairing their ability to effectively plan and implement their programs. The volatility of TP and D revenues makes it difficult for local agencies to forecast state apportionments from the account and makes the state's ability to fund past commitments for transit capital improvement projects highly uncertain. Consequently, we think that it is essential for the Legislature to provide a degree of stability in this account's funding comparable to that of other state accounts.

We also conclude that if previous local transit capital commitments are to be funded and current state mass transportation and planning activities maintained, the account will need more revenue in 1985–86.

We therefore recommend that legislation be enacted to restructure the TP and D funding mechanism by financing the TP and D Account directly from revenues generated by the retail sales tax on fuel, including gasoline *and* diesel. Implementation of this recommendation has three main advantages: (1) it would increase funding stability, (2) it would allocate costs between operators of gasoline and diesel powered vehicles more equitably, consistent with the "user charge" principle, and (3) it would provide a sufficient level of funding ($396 million over five years) to cover previous commitments made for transit capital projects, as well as maintain existing program levels.

More Equitable Truck Weight Fees Should Be Established

We recommend that the Legislature adopt a vehicle weight fee schedule based on vehicle laden weight and on miles traveled.

Currently, California's truck weight fee is based on the *unladen,* or empty, weight of the vehicle and makes no allowance for the mileage traveled by the vehicle during the course of a year. A vehicle's laden, or loaded weight, and distance traveled while loaded, however, better represent the vehicle's actual contribution to road pavement damage. Consequently, the current system fails to allocate equitably the cost of maintaining the state's highways in accordance with the actual use of, and damage inflicted on, those highways by various commercial vehicles.

Various federal and state studies have identified this bias in favor of heavy vehicles at the expense of light vehicles, and have recommended that the current system be changed to eliminate it. Because a laden weight-distance fee would establish more equitable user charges, we recommend that the Legislature adopt a truck weight fee structure which is based on vehicle laden weight and miles traveled. Such a fee structure would be a more effective means of allocating highway maintenance and construction costs to the users of the services. A more comprehensive discussion of the laden weight and distance concept of assessing truck weight fees is presented in our 1984 report entitled *Assessment of Weight Fees on Farm Vehicles in California.*

TAX EXPENDITURES

Should the Legislature Adopt the Department of Finance's Recommendations Regarding Tax Expenditures?

The term "tax expenditures" refers to the various tax exclusions, exemptions, preferential tax rates, credits, and deferrals which reduce the amount of revenue collected from the state's basic tax structure.

The Department's Tax Expenditure Recommendations

The Governor's Budget for 1985–86 contains a report on tax expenditures (pages 70–80), prepared by the Department of Finance. In addition to providing basic data on the state's current tax expenditures, the department's report contains three specific recommendations. The first two of these recommendations deal with tax expenditure reporting and review. Specifically, the budget proposes that:

1. The Legislature *reconsider the definition* of a tax expenditure, with

a view toward formulating a more "narrow and useful concept," and

2. Any legislation authorizing a new tax expenditure include a *three-year sunset provision,* so that the Legislature will have an opportunity to consider the costs of the tax expenditure and confirm that it is accomplishing its intended purpose.

The third recommendation set forth in the budget calls for a change in the way the state's tax expenditures for solar and energy conservation tax credits are treated. Specifically, the Department of Finance recommends that:

3. The solar and energy conservation credits be (a) funded directly, through a Budget Act *appropriation,* instead of indirectly, through the current tax expenditure mechanism, and (b) funded at only *50 percent* of what current law would allow for these credits in 1985–86.

Formal Process Needed for Review and Oversight of Tax Expenditures

We recommend that the Legislature establish a formal process for review and oversight of tax expenditure programs.

As we discussed in last year's *Perspectives and Issues* (please see pages 132–137), tax expenditures should receive the same degree of legislative oversight as direct expenditures, especially given that such a substantial amount of resources is devoted to tax expenditure programs—resources that otherwise would be available to the Legislature either for use in accomplishing its policy objectives through direct expenditure programs, or for broad-based tax relief.

The department's recommendations to redefine tax expenditures and require an automatic three-year sunset for all newly-enacted tax expenditures would not, in our judgment, bring about a significant improvement in the Legislature's ability to review and oversee tax expenditure programs on a regular basis. This is because:

- The vast majority of items on the department's current listing of tax expenditures belong there,
- Although three-year sunsets may be appropriate for certain new tax expenditures, a mandatory three-year sunset is too mechanical to be appropriate for all new tax expenditures, and
- The proposed sunset for new tax expenditure programs does not improve the Legislature's ability to deal with the many *existing* tax expenditures.

This is not to imply that the inclusion of sunset provisions in legislation establishing new tax expenditures is necessarily a "bad" policy; in fact, in many cases sunsets may be the best policy. Sunsets, however, are best applied on a case-by-case basis, so that the need for a sunset and the appropriate length of time before a sunset review is conducted can be properly determined, based on the unique nature of the particular tax expenditure in question.

Last year, we indicated that what the Legislature *does* need is a *formal process* for reviewing and overseeing tax expenditure programs. We suggested several options for establishing such a process (please see *Perspectives and Issues,* page 135). During 1984, the Legislature enacted AB 1894, which would have implemented one of these options—a requirement that the Governor annually submit a "Tax Expenditure Budget." The Governor, however, vetoed this bill.

Given the administration's unwillingness to take the lead in reviewing existing tax expenditures, the Legislature may wish to proceed with one of the other three options that we suggested last year. Regardless of the exact approach which the Legislature chooses, however, we believe that a formal legislative process for reviewing and overseeing tax expenditure programs is needed if these programs are to be monitored properly.

Energy Tax Credits Should be Phased Out

We recommend that legislation be enacted which reduces the value of the solar and energy conservation tax credits by 50 percent.

Under current state law, individuals and corporate taxpayers are allowed to claim tax credits for the partial cost of both solar energy systems and energy conservation measures, subject to various limitations. In 1984, approximately 200,000 taxpayers claimed a total of $41.5 million in energy conservation credits, and 83,000 taxpayers claimed a total of $78.2 million in solar energy credits.

The Governor's Proposal. Item 9100 of the 1985 Budget Bill requests a direct General Fund appropriation of $68.5 million to fund the energy tax credit programs during the budget year. This appropriation would be in lieu of the open-ended tax credit now available to taxpayers when they file their tax returns. The proposed appropriation is equal to one-half of the $137 million in foregone revenues that would result from the current tax credit mechanism in 1985–86. Thus, the budget assumes that a 50 percent funding *reduction* for these credits could be achieved through the Budget Bill.

The Governor believes that a lower tax subsidy is justified because the solar energy and energy conservation industries have had sufficient time to establish themselves in the marketplace and no longer need as much state support in order to survive and prosper. In addition, the budget points out that the benefits from these subsidies have accrued primarily to higher-income taxpayers who are able to pay regular market prices for solar energy systems and energy conservation measures, without state tax subsidies. Finally, the Governor wants to begin a phase-out of these credits prior to the end of 1986, when they would be terminated under existing law, so as to provide a "clear signal" that the credits will not be extended.

Issues Raised by the Proposal. The Governor's proposal raises three separate policy issues, as discussed below.

1. Could the funding reduction be achieved through the Budget Bill? The department's aim in funding the tax credits through a direct appropriation is to reduce the level of state subsidies for solar energy and energy conservation. To do this, it simply proposes to make funds available, through the budget process, for one-half of the estimated level of credits that would otherwise be claimed. The proposal does not *limit* the amount of the credits which may be taken by taxpayers in filing their tax forms, which is a necessary step in order to reduce the level of credits paid.

At the time this analysis was prepared, however, the administration had not proposed the statutory changes needed to achieve the reduced funding level. Unless such new legislation is enacted, taxpayers in 1985–86 still would be allowed to deduct the *full amount* of the credits provided under current law, even if the funding for the credits were limited to a lesser amount in the Budget Act.

Our detailed analysis of the proposed appropriation appears under Item 9100 of the *Analysis,* where we recommend that it not be approved in its current form.

2. Should funding for the energy-related tax credits be appropriated in the Budget Act? We believe that using direct appropriations to fund individual state expenditure programs generally is the most desirable means for accomplishing the Legislature's objectives. Direct appropriations offer the Legislature the best opportunity to review and control individual spending programs, and to compare the costs and benefits associated with these programs to those associated with competing state programs.

Since the state does not appear to realize any significant administrative cost savings by funding energy-related tax credit subsidy programs through the tax expenditure mechanism, we believe that funding these programs through a direct appropriation makes sense. However, legislation would be necessary to restructure the program in a fashion compatible with direct Budget Act funding.

3. Should the funding for the tax credits be reduced? With regard to this last issue, we conclude that currently there is no analytical basis for setting the tax credits at *any* particular level. We are not aware of any evidence which demonstrates that a particular percentage credit is the most cost-effective, or that any "minimum percentage" credit is necessary to stimulate additional investment in energy conservation or solar devices. In fact, we doubt that any *single* credit level would be equally appropriate to the full range of potential solar and energy conservation applications and technologies.

On the other hand, it does appear that a reduction in the state subsidy for solar energy and energy conservation can be justified. It is not clear that state credits are still needed in order to help stimulate and develop the energy conservation and solar industries. In fact, a recent report by the California Energy Commission concludes that the solar industry has shown substantial growth over the past several years. This is based on evidence that 1,500 businesses directly work in the solar field and an additional 5,500 companies perform part-time work.

Tax return information from the state Franchise Tax Board (FTB) also shows that the benefits from the credit have accrued mainly to higher-income taxpayers, who do not need state subsidies to make solar and energy conservation investments affordable. According to FTB data, for example, nearly 70 percent of the amount of solar energy credit claims filed under the personal income tax in 1982 were claimed by taxpayers with adjusted gross incomes of over $50,000. Moreover, it appears that the credits are being used increasingly by high-income taxpayers for investments that serve mainly as tax shelters. Among these, one of the most popular is the solar windmill, which provides investors with state and federal tax credits, an accelerated depreciation deduction, and income from the sale of electricity to utilities. Between income years 1981 and 1982, the number of credit claims for solar windmills jumped from 122 ($2.6 million) to 1,894 ($25.6 million). For over one-half of the taxpayers who claimed this credit for the 1982 income year, the credit allowed them to reduce their net state tax payment to zero.

For these reasons, we agree that a reduction in the credit amount during 1985–86 would be warranted. Such a reduction could be achieved through an across-the-board reduction; by reducing the credit for taxpayers with higher incomes, as the Governor proposes; or even by repealing the credits one year prior to the scheduled sunset date of December 31, 1986. In our view, the most straightforward way to achieve the Governor's objective would be to simply reduce the value of the credits by 50 percent. Such a reduction would achieve the funding goal of the budget, and would also tend to phase-out, rather than abruptly cancel, a tax savings which is scheduled for termination on December 31, 1986. Accordingly, we recommend that the Legislature enact legislation which reduces the value of the solar energy and the energy conservation tax credits by fifty percent.

Expenditure Issues

STATE WORK FORCE REDUCTION PROPOSAL

What Effect Will the Governor's Proposed Staffing Reductions Have on State Programs and Activities? How Much Money Will These Reductions Save?

As discussed in detail in Part Two of this document, the Governor's Budget proposes a state government work force of 227,888 personnel-years in 1985–86. This is a reduction of 2,869 personnel-years from what the budget estimates the current-year level to be. This section analyzes the Governor's staffing reduction proposal in an effort to evaluate its effect on state operations and expenditures.

Background

Table 47 summarizes trends in state staffing since 1977–78. It shows that, despite a significant decrease in the actual staffing level after the passage of Proposition 13, the state's work force grew by 5,444 personnel-years between 1977–78 and 1983–84, the last year for which data on *actual* staffing levels are available.

The budget shows that the state's work force in the current year is *4,062 personnel-years larger* than what the work force actually was in 1983–84. This is the second largest year-to-year increase, both in absolute and percentage terms, since Proposition 13. The current-year figures shown in the budget, however, are only *estimates* of the state's 1984–85 work force. The actual size of the work force may vary significantly from this level.

Table 47
State Personnel-Years
1977–78 through 1985–86

	Proposed In Budget	*Subsequent Change*	*Actual*	*Change From Prior Year*
1977–78	215,796	5,455	221,251	—
1978–79	224,337	−5,807	218,530	−2,721
1979–80	218,619	1,574	220,193	1,663
1980–81	221,118	4,449	225,567	5,374
1981–82	226,743	2,070	228,813	3,246
1982–83	231,375	−2,886	228,489	−324
1983–84	232,371	−5,676	226,695	−1,794
1984–85	229,540	1,217 [a]	230,757 [a]	4,062 [a]
1985–86	227,888	—	—	−2,869 [b]

[a] Estimated.
[b] Proposed.

One should view state personnel-year totals, such as those shown in

Table 47, with great caution, however. This is because a change "in the numbers" may not be a reliable guide to the direction in which state policy is actually heading, and may not give any indication as to the implications that changes in personnel-years have for state programs and expenditures. This certainly seems to be the case with respect to both the numbers on state employment that are contained in the Governor's Budget, and the interpretation put on these numbers in the budget document.

In the balance of this section, we consider the claims made in the Governor's Budget regarding the state work force, from five different perspectives:

1. What can be concluded from budget estimates of the total state work force?

2. What personnel-year changes are occurring in 1984–85, and how do they affect 1985–86 staffing estimates?

3. To what extent are the proposed personnel-year reductions the result of "increased efficiencies and economies"?

4. How much has been saved as a result of the proposed reductions?

5. What effect will the proposed reductions have on the quantity and quality of services provided to Californians?

What Can be Concluded From Budget Estimates of the Total State Work Force?

State work force reductions have been a central theme of the Governor's Budget for both 1984–85 and 1985–86. Most of the discussion in the budget pertaining to the state's work force revolves around the number of "personnel-years" worked by state employees.

As discussed below, this measure of the state's work effort is not entirely satisfactory. Unfortunately, other available methods are similarly flawed. What makes it difficult for the Legislature to evaluate the claims and counter-claims regarding changes in the state work force is the absence of a comprehensive statewide system for tracking the level of the state's work force.

Currently, the state's system of accounting for its staff is tied to the disbursement of paychecks. The system is geared to ensuring that a given individual is occupying a position authorized by the Legislature and is working the requisite number of hours. Thus, the State Controller, who issues the vast majority of these paychecks, is the main source of information about state personnel-years.

It is difficult, however, to use annual personnel-year data for more than general trend analysis. Two factors account for this. First, the "system" was essentially designed for payroll purposes and, therefore, lacks the standardization and comprehensiveness of a statewide position control system. Second, wide variations in personnel-year estimates occur between the time a budget is introduced and some 18 months later when the programmatic work envisioned in the budget is actually completed.

The following discussion outlines various aspects of the state's system in order to facilitate the evaluation of claims that are based on information from the system.

How does the state measure the size of its work force? There are three distinct ways that the level of state employment or staff effort can be expressed:

- The number of *employees*—the people performing the work,
- The number of *positions*—the slots authorized by the Legislature that individuals fill, and
- The number of *personnel-years*—the amount of time that slots are actually occupied by individuals.

For budget purposes, "personnel-years," or "pys," is used most often, because it represents the full-time staffing effort devoted to a particular function.

While the three terms may be synonymous, they often are not. For example, *two* individuals may fill *one* position, and each work a 10-hour week, thus yielding *one-half* a *personnel-year.*

Why is the staffing distinction important? The distinction between the various measures of the state's work force is important because the use of different measures can result in different answers to key questions about trends in the state's work force. For example, on a personnel-year basis, civil service staffing *declined* by 887 pys between 1982–83 and 1983–84. On an employee basis, however, there were 2,246 *more* full-time civil service employees at the end of June 1984 than there were at the same time one year earlier.

Are all state personnel reflected in the budget totals? No. Because the Controller does not process the payroll for all state employees, not all state personnel are reflected in the budget's work force totals. In addition, some employees have traditionally been excluded. Among those state employees not included are legislative staff (except those employed by the Legislative Counsel Bureau, who have civil service status), staff from certain district fairs that receive a state paycheck, and members of the national guard who are on active duty.

While staff of the University of California (UC) is reflected in the budget totals, the university is not part of the Controller's payroll system. The university prepares its own payroll and provides data concerning its staffing level directly to the Department of Finance. It is by no means clear just what the UC numbers mean—particularly estimates of these numbers—because the university does not have a position control system like the rest of state government. In the case of UC, it is *funding,* rather than authorized positions, that really determines staffing levels at the university. Because the university accounts for such a significant portion of the state's work force (25 percent in the budget year), however, a modest percentage change in the university's staffing level can have a significant effect on the statewide totals.

The personnel system used for the California State University (CSU), on the other hand, is more like the rest of the state's. Nevertheless, the state has delegated most of the personnel tracking function for CSU to the Chancellor's Office. Because the system also accounts for a large portion of the state's work force (14 percent in the budget year), modest percentage changes in CSU staffing can make a significant difference in the statewide totals.

Is all staffing effort reflected in the personnel-year totals? No. Both overtime and temporary help are important contributors to the state's work effort. Both of these categories, however, are controlled by the amount of *money expended* to pay staffing costs, rather than by the number of employees maintained or positions authorized. Although the budget contains an estimate of the personnel-years worked on a temporary help basis, it does not provide similar accounting for *overtime* work. Thus, if 10 full-time employees each work four hours of overtime each week so that an authorized position can be kept vacant, the number of personnel-years reported in the budget will go down, even though the work effort remains the same.

Personnel-Year Estimates

Chart 19 illustrates three common patterns that show up in state employment estimates: (1) midyear estimates of staffing levels typically are higher than the original budget estimates, (2) inflated midyear estimates make the number of personnel-years proposed in the budget year look smaller, and (3) midyear estimates of personnel-years in recent years tend to overstate the *actual* number of pys worked.

Proposed Versus Midyear Estimates. Chart 19 shows that, in five of the last six years, the midyear estimate of the total state work force has been higher than what the original budget for that year proposed. This is usually the case, for two reasons: (1) proposed staffing levels typically are increased by the administration and the Legislature during the course of deliberations on the budget and (2) new positions are created administratively after the budget is enacted, in order to provide sufficient staff to perform needed functions.

Inflated Midyear Estimates Make Budget Proposals Look Smaller. The chart also shows that, beginning in 1982–83, midyear estimates for the budget just enacted have been higher than the personnel-year level proposed for the following year. This has the effect of making it look as though the state work force is being pared back, when, in fact, the number of pys proposed for the budget year exceed *actual* pys in the prior year. The Governor's Budget for 1985–86 provides a good illustration of this. While the proposal for 1985–86 (227,888 pys) is *less* than the midyear estimate (230,757 pys) for 1984–85, it is 1,193 pys *higher* than pys in the prior year (226,695 pys).

Midyear Estimate Versus Actual Staffing. A more recent phenomenon also is illustrated in Chart 19. In both 1982–83 and 1983–84, the state's actual staffing level turned out to be significantly below the midyear estimate (by −4,897.4 pys and −7,724.8 pys, respectively). Our review indicates that most of the difference can be explained by two factors: delays in the Department of Corrections' prison construction program and the hiring freeze at the Employment Development Department (EDD). Given the continuing delays in the prison construction program and the workload and organizational changes at EDD, the actual personnel-year totals for these two departments in 1984–85 also are likely to come in below the original and midyear estimates. Thus, it is probable, all else being equal, that the staffing level shown for 1985–86 in next year's budget will exceed, rather than be less than, the actual staffing level for 1984–85.

Chart 19

Trends in State Employment Estimates 1979–80 through 1985–86 (in thousands)

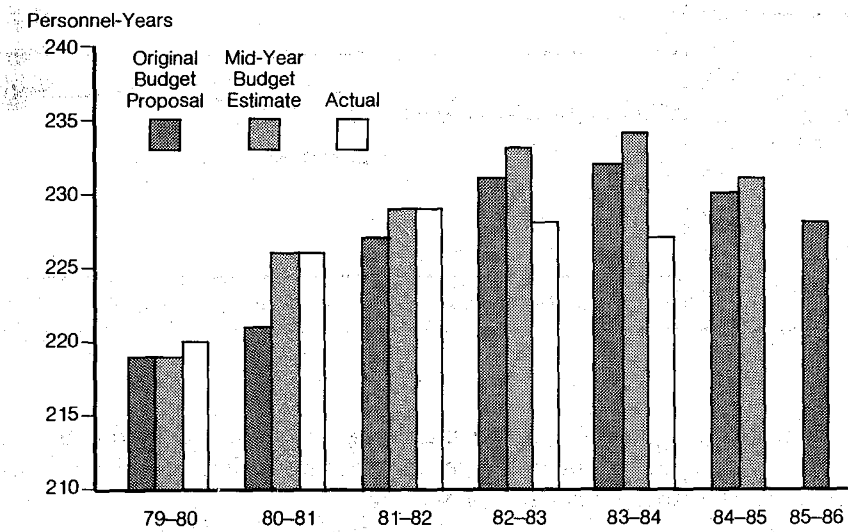
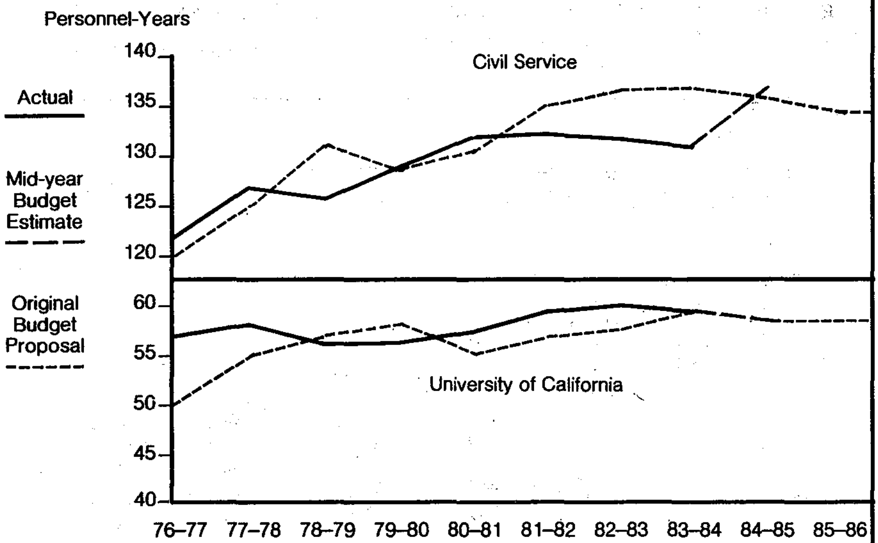


Chart 20 also illustrates the relationship between actual and estimated staffing for the two largest personnel classifications in the state's work force—civil service and the University of California. The chart shows that, between 1981–82 and 1983–84 (the last year for which actual data are available), there was a tendency to *underestimate* University of California staffing in the original budget, relative to actual staffing levels. The pattern for civil service staffing is the reverse—a tendency for the budget to *overestimate* staffing, relative to actual experience. Much of the civil service pattern can be attributed to staffing shortfalls for the Department of Corrections and EDD, as discussed earlier. With regard to UC, however, we assume that much of the explanation for the underestimates lies in the fact that the state has no position control over the university.

Chart 20
Civil Service Versus University of California Personnel Estimates
1976–77 through 1985–86 (in thousands)



In summary, a change "in the numbers," as reflected in the budget document, generally does not give an accurate indication of what the trend in state staffing has been or will be.

With this in mind, we turn now to specific aspects of the Governor's proposals for the state work force in 1985–86.

What Personnel-Year Changes are Occurring in 1984–85, and How Do They Affect 1985–86 Staffing Estimates?

As noted in the previous section, midyear estimates of personnel-years are usually not reliable indicators of what the actual work effort for a given year will be. Our analysis indicates that this will turn out to have been the case with respect to the midyear estimate for 1984–85. Because the midyear estimate of the state's staffing level in 1984–85 is the base against which the proposed staffing level for 1985–86 often is compared, this estimate warrants a careful review.

As shown in Table 48, the revised estimate of total state personnel-years for 1984–85 is only 447 pys higher than what it was when the 1984 Budget Act was chaptered. This relatively modest increase, however, masks at least three significant changes: (1) an *accounting adjustment* that has reduced the staffing level reported for the California State University (CSU) by 477 pys, (2) a *workload* adjustment that allowed the Employment Development Department to reduce staffing by 276 pys, and (3) the *discretionary* increases in staff made by the administration that have added approximately 1,200 pys to the current-year staffing totals. Each of these changes is discussed below.

Table 48
Changes in Personnel-Years for 1984–85
Between January 10, 1984 and January 10, 1985

Staffing proposed in the Governor's Budget (1-10-84)	229,540	
Net staffing added by Finance Letters	+973	
Governor's Budget (revised)	230,513	
Legislative changes in staffing levels	+610	
Staffing included in Budget Bill, as passed by the Legislature	231,123	
Staffing vetoed by the Governor	−813	
Staffing included in the 1984 Budget Act	230,310	
Subsequent changes in staffing		
Accounting adjustment for CSU teaching		−477
Reduced personnel-years in Employment Development Department, due to workload decreases		−276
Personnel-years added *after* the budget was chaptered		+1,200
Total net personnel-years added by the administration		447
Current estimate of personnel-years	230,757	

1. Accounting Adjustment for CSU. The Department of Finance has adjusted the estimate of CSU's staffing level, presumably to avoid double-counting full-time faculty who teach in both daytime academic programs and extension classes at night or on weekends. The adjustment provides that this staffing effort will now be considered overtime, and therefore will no longer be reflected in statewide totals of personnel effort. This adjustment was made to the CSU's actual personnel-years for 1983–84 (−506 pys), as well as to the estimated level for 1984–85 (−477 pys), and the proposed amount for 1985–86 (−502 pys).

Thus, when the administration claims that it has reduced state employment, it includes in the reduction about 500 personnel-years that have simply been *defined* out of existence. In this case, there is no less work being done by state employees, nor is there less money being spent for this work; the work effort has merely been dropped from the total.

2. Employment Development Department. The Legislature included language in the 1984 Budget Act directing the department to review its staffing needs in administering the unemployment insurance and disability insurance programs. As a result of this directive and lower-than-anticipated unemployment rates, the department anticipates deleting 276 pys in the current year.

3. Administrative Adjustments in 1984–85. The nature of state operations is such that numerous staffing adjustments are required throughout the year in order to implement various state programs and respond to changing workload. Our analysis indicates that, disregarding the reductions noted above, the administration has added a net of 1,200 pys since the budget was enacted. This adjustment reflects the net effect of various position additions and deletions.

Thus, although the estimate of 1984–85 staffing levels has changed only slightly since the 1984 Budget Act was chaptered, the small change in the totals masks larger workload and policy changes that are occurring in the current year and are carried forward into the budget year.

To What Extent Are the Proposed Personnel-Year Reductions the Result of "Increased Efficiencies and Economies"?

Information provided to the Legislature in support of some position reductions proposed for 1985–86 documents that the reductions have been made possible by increased efficiencies and economies. While "increased efficiencies and economies" will indeed enable the state to eliminate some positions in the budget year, most of the reductions in personnel-years proposed by the administration reflect other factors. Some of the more important of these factors are discussed below.

Bookkeeping Adjustments Inflate Savings. There are a number of instances where personnel-year totals *appear* to be declining when, in fact, no change in work effort is being proposed. The reason for the apparent change is simply a change in bookkeeping. As discussed above, the apparent "savings" in CSU's staffing (502 pys in the budget year) falls into this category.

The Department of Corrections, for example, is "saving" 185 pys by eliminating officer positions and using the funding, instead, to pay for overtime work by the remaining employees. Thus, although there will be no reduction in work effort and no reduction in expenditures, the administration is able to report a reduction in state employment of 185 pys (since overtime work is not reflected in personnel-year totals).

The Health and Welfare Data Center, and the Departments of Food and Agriculture, Fish and Game, and Forestry, collectively, show a "savings" of 106 pys by changing the manner in which temporary help personnel is reflected in their respective budgets. Nevertheless, funding remains in these budgets so that state employees can perform the needed services.

Thus, our analysis indicates that the level of the state's work force in 1985–86 is at least 793 pys lower as a result of bookkeeping adjustments.

Unallocated Reductions Inflate Savings and Limit Legislative Control. The Governor's Budget for 1985–86 also proposes several unallocated personnel-year reductions. For example, the budget shows that 250 unspecified positions at CSU will be eliminated. The funding associated with the personnel, however, remains in the budget. The administration advises that a plan detailing these position reductions will be submitted during budget hearings. (If last year's pattern is followed, this reduction also may end up in the "bookkeeping change" category.)

Unallocated reductions take another form as well: an unreasonable increase in the salary savings rate (which reflects the period of time during which authorized positions are vacant). An artificially high salary savings rate will require the affected departments to purposely hold vacant positions open.

Our analysis indicates that both the State Personnel Board (SPB) and the Public Employees' Retirement System (PERS) will almost certainly have to hold positions vacant to achieve artificially high salary savings rates imposed on them by the 1985–86 budget. We estimate that the SPB will have to keep nine authorized positions vacant, while PERS will have to keep 22 authorized positions open. Similarly, Caltrans will have to hold enough authorized positions open to reduce personnel-years by 100. Our analysis indicates it would be very difficult for any of the three departments to meet the requirement without reducing departmental program activities.

These excessively high salary savings requirements mean that individual departments, rather than the Legislature, will decide which positions to leave open, and thus which program activities will be cut back.

Personnel Reductions in Individual Program Areas Are Explained by Other Factors. Our review of the position reductions proposed in the budget indicates that, in many cases, the reductions are due, not to "increased efficiencies," but rather to factors that are beyond the control of the administration. For example, of the proposed personnel-year reductions:

- 715 in the *Employment Development Department* result from (1) the scheduled termination of federal programs (292 pys) and (2) declining caseload in the unemployment insurance program, due to a projected decrease in unemployment (423 pys).

- 175 in the *Department of Motor Vehicles* are due to increased automation, and were first identified in *1978* when the department's automation project began.
- 350 in the *University of California's* teaching hospitals were anticipated *three years ago* when the Legislature enacted Medi-Cal reform legislation.
- 118 in the *California Highway Patrol* reflect the termination of the training phase of the AB 202 program, which added 670 new patrol officers.
- 1,200 are positions that were *administratively established* in 1984–85. Pursuant to state guidelines, these positions cannot continue beyond the current year, unless specifically authorized by the Legislature. (An unknown portion of these positions have been requested in 1985–86.)
- 872 are *limited-term positions* that are *automatically* deleted from the budget.

Summary. The administration's 1985–86 staffing proposal includes significant staffing reductions, along with some staffing increases (most notably in Youth and Adult Corrections, +1,830 pys). On balance, the budget claims that the administration is reducing the work force in 1985–86 by 2,869 pys from what it estimates the current-year staffing level to be.

Our analysis indicates that the administration has taken credit for reductions that are due to factors which either are not attributable to actions taken by the administration, or reflect bookkeeping changes or unidentified reductions—as well as "increased efficiencies and economies." Moreover, the size of the base from which the reduction is measured has been augmented by 1,200 personnel-years that were added administratively after the 1984 Budget Act was chaptered. Finally, the estimate of the base year (1984–85) staffing level is probably inflated, given the pattern reflected in Chart 19.

From the Legislature's perspective, however, the size of the reduction is not the real issue. Instead, the issue is: What effect will the elimination of *individual* positions have on the quality and cost of services provided by the state? This necessitates a function-by-function review to ascertain whether an adequate staffing complement is available to carry out the program priorities of the legislative branch.

How Much Has Been Saved as a Result of the Proposed Reductions?

The Governor's Budget (Schedule 4) indicates that, despite the projected elimination of 2,869 personnel-years, net salary and wages (that is, salary and wages adjusted for salary savings) for state employees will *increase* from $6.5 billion in 1984–85 to $7.0 billion in the budget year, an increase of $503 million, or 7.8 percent. Is such an increase reasonable, given the savings that should result from such a large reduction in personnel-years?

In order to determine the extent to which the Governor's proposed staffing reductions have produced savings, we derived a *base level* of salary expenditures. We did so by subtracting from the net total salaries and wages amount shown in the budget for both the current and budget year: (1) the unallocated employee compensation amounts (which include the proposed salary package for 1985–86) and (2) the incremental adjustment required in the budget year to pay midyear salary increases provided in 1984–85 to specified civil service, UC, and CSU employees. Table 49 shows that, when these adjustments are made, "base" salary and wages are $21 million *higher* in the budget year than in the current year. Assuming, however, that the 2,869 personnel-years earned the average state salary of $28,078, the administration's staffing changes *should have* resulted in a net salaries and wages savings of approximately $81 million. Thus, the budget requests approximately $102 million *more* than what we estimate would be saved if the 2,869 personnel-years were paid the average salary. (A part of this difference can be explained by the *additional* funding provided in the budget for merit salary adjustments. The Department of Finance advises that $35.1 million from the General Fund was added for this purpose.)

In summary, despite the staffing reductions proposed for the budget year, we have been unable to identify dollar savings that in any way are commensurate with the personnel changes indicated in the budget. Similarly, neither the Budget Bill nor the budget document appear to reflect this change. Where did the money go? What implications does the failure to reduce these funds have for the Legislature? We address these questions below.

Table 49
Adjusted Net Salaries and Wages
1984–85 and 1985–86
(dollars in thousands)

	1984–85		*1985–86*
Salaries and Wages	$6,677,739		$7,214,457
Salary Savings	−198,577		−232,789
Net Totals	$6,479,162		$6,981,668
Adjustments:			
Unallocated employee compensation	−32,828		−488,111 [a]
Special salary adjustments [b]	—		−26,672
Base salaries and wages	$6,446,334		$6,466,885
Difference		+$20,551	

[a] The amount set aside in the budget for salary and benefit increases for civil service and higher education employees.

[b] Reflects the increment required to fund midyear salary increases initiated in 1984–85 for specified civil service, UC and CSU employees.

We have identified numerous instances where (1) personnel-years have been reduced but funding for these pys has been left in the budget, (2) the salary and benefit costs associated with deleted positions have been underestimated, so that part of the funding for the deleted positions remains in the budget, (3) departments have redirected the savings from personnel cuts to other activities, and (4) the dollars associated with reduced state positions will be used to contract with the private sector for staffing services instead.

*1. **Staffing Reduced But Not Associated Funding.*** As discussed earlier, the budget proposes a number of personnel-year reductions without proposing any corresponding funding changes. The budget for the California State University, for example, shows a reduction of over 750 personnel, but *no dollar reduction* for these positions. Similarly, the budget for the University of California shows a reduction of 250 pys, but *no dollar reduction.* In addition, the budget for five entities (the Departments of Corrections, Food and Agriculture, Fish and Game, and Forestry, as well as the Health and Welfare Data Center) show a collective reduction of approximately 290 personnel-years but *no funding reduction.* Thus, the funds associated with more than 1,250 personnel-years proposed for elimination remain in the budget. This clearly is another case where a change "in the numbers" does not tell the whole story.

*2. **Savings Resulting from Reduced Staffing Has Been Underestimated.*** Our analysis has found that several departments propose to reduce funding for terminated positions on the assumption that these positions are budgeted at the minimum step of the salary range, when the positions actually are budgeted at higher levels. Table 50 shows that an additional $4.6 million could be saved in these five departments alone if salary and benefit reductions are made that more closely mirror actual salary levels.

Table 50
Funding for Salaries and Benefits That Should Be Reduced *If* the Legislature Approves Proposed Personnel Reductions (dollars in thousands)

Employment Development Department	$3,512
Department of Rehabilitation	536
Department of Social Services	245
Department of General Services	173
State Personnel Board	116
	$4,582

*3. **Redirected Savings.*** Several departments took the savings associated with staffing changes and redirected the funds to other activities. Thus, state expenditures remain unchanged. For example, the Department of Parks and Recreation realized a $415,000 savings by deleting 29 pys of seasonal staff in favor of utilizing California Conservation Corps

(CCC) personnel. The department proposes to use these funds to (a) purchase vehicles to transport corps members to job sites, (b) provide housing for corps members, and (c) fund additional operating expenses. The CHP, on the other hand, proposes to use $1.5 million of its savings to (a) purchase and operate four new airplanes and (b) pay for various staff-related costs, including relocation expenses.

4. Contracts for Staffing Services. As discussed in more detail in the next section, there are numerous examples of where the dollars associated with personnel-year reductions are proposed for use in contracting out for services. For example, the Department of Corrections proposes to eliminate 18 pys performing microfiche activities and instead use the $257,000 it would have cost to retain these staff to fund a contract for the needed services. Similarly, Caltrans proposes to eliminate 45 pys needed for right-of-way maintenance and instead use the $1.6 million it would have cost to retain these personnel to fund the needed work on a contract basis.

Failure to Reduce Funding Leaves Program Control in the Administration's Hands. Thus, our analysis indicates that an unknown, but significant, portion of the funding associated with the personnel reductions remains in the budget—either in the form of salaries and related expenses or as part of departmental support. To the extent extra money remains—the administration, rather than the Legislature—largely will be making the program-related decisions on how to use these funds.

What Effect Will the Proposed Reductions Have on the Quantity and Quality of Services Provided to Californians?

Of all the questions raised by the Governor's staffing proposal, this is the most difficult one to answer. This is because many of the proposals for reducing staff or contracting for personal services are still evolving. In many instances, the effects on programs of these proposed changes are, at best, unclear at this time. In several instances, however, the effects on services *are* apparent and warrant legislative consideration.

- ***The Office of Economic Opportunity (OEO).*** Pursuant to legislative direction in the 1984 Budget Act, the administration has reviewed OEO's organizational structure and reduced 26 pys. The savings associated with this change, $438,000, has been redirected to program activities which should result in increased local services for OEO clients.
- ***The Youth Authority*** is reducing 16 positions and $404,000 (federal funds) which are used to provide remedial reading, language development, and remedial math services to its wards. Twelve of these positions are teaching assistants who provide these services directly; the remaining four are related support staff. The proposed elimination of 12 teaching assistants represents a 22 percent reduction in the total number of teaching assistants in the department. We question

the budget's contention that elimination of the positions will not adversely affect the level of services provided to wards.

- ***Social Services.*** The budget proposes to transfer the responsibility of providing specified adoption services to the counties. Counties will receive $2.6 million to cover their costs. Our analysis indicates that the proposal would result in fewer children being adopted.
- ***Vocational Rehabilitation.*** The Department of Rehabilitation proposes to eliminate 88 personnel-years and instead contract for the provision of vocational rehabilitation services to disabled persons. No evidence has been submitted, however, to document that the needed services can be obtained from private providers on a cost-effective basis.
- The ***California Highway Patrol*** proposes to eliminate the traffic management helicopter in the Los Angeles area, in the hope that another agency will take over this service. At this point, however, no formal agreement has been signed that ensures continuation of this service.

In summary, it appears that a number of the Governor's personnel-year proposals would result, or potentially would result, in reduced services to the people of California.

Conclusion

In sum, our review of the administration's work force reduction proposal has found that:

- The 1984–85 estimate of the state work force is not a very reliable base against which the number of personnel-years proposed for 1985–86 should be compared. This is because the current-year estimate, more than likely, is overstated and, therefore, tends to exaggerate the size of the reduction proposed for the budget year.
- The administration's proposed staffing reduction for 1985–86 is attributable to increased efficiencies and economies, bookkeeping adjustments, unallocated reductions, and reductions which would have occurred in the absence of administrative actions or have been anticipated for several years.
- A large number of positions would be eliminated in the budget year, if the administration's proposals are adopted. The extent to which the total work force in 1985–86 will turn out to be lower than the work force in 1984–85, however, is unclear.
- Dollar savings commensurate with the proposed staffing reduction are not reflected in the budget. In fact, adjusted salary costs are up, not down, in the budget year.
- Several of the administration's personnel reduction proposals would result in reduced services to the people of California.

What Criteria Should the Legislature Use in Evaluating the Governor's Personal Services Contracting Proposals?

As discussed in the previous section, the budget includes a great deal of money that would be used to contract out for staffing services. Much of this money would be freed up by personnel reductions proposed in the budget.

Personal services contracting is not a new activity for state government. The state often has contracted for specialized staff who have a particular expertise. Departments also enter into contractual arrangements with each other when specialized services, such as data processing, are required. What is unique about the Governor's proposal is that a significant number of the proposed new personal services contracts would be let for the types of work currently performed, or traditionally performed, by state employees.

In many instances, it seems obvious that funding for a personal services contract has been proposed in the budget primarily for the sake of reducing the state's staffing level. Often, the proposal appears to have been developed without first ensuring the contract's actual viability—its legality, feasibility, cost-effectiveness, or program impact. This will make it exceedingly difficult for the Legislature to determine whether the proposal has merit.

Our analysis indicates that the Governor's Budget contains funds for more than 100 new personal services contracts in lieu of hiring state personnel. Table 51 provides our best estimate of the personnel replaced or avoided in the budget year as a result of these contracts. The table shows that approximately 1,300 state personnel-years are affected by the contracting proposals. This estimate, moreover, is conservative because (1) it only includes those instances where state staff are performing or traditionally have performed the function to be contracted out for the budget year, (2) it does not include ongoing contracts entered into in past years, and (3) it only includes those personnel which were clearly identifiable as a result of information provided by individual departments.

Not only are these new contracts significant from a personnel standpoint, they also involve a significant amount of money—at least $64 million (all funds). Contract amounts range from as little as $23,000 for the Public Employment Relations Board to obtain legal services to as much as $11 million for the Department of Rehabilitation to secure vocational rehabilitation services for its clients.

Table 51
Personnel-Years Replaced or Avoided in 1985–86 As a Result of New Contract Proposals

Legislative, Judicial, Executive	11.1
State and Consumer Services	194.9
Business, Transportation and Housing	369.4
Resources	70.4
Health and Welfare	406.9
Youth and Adult Corrections	18.0
K–12 Education	—
Higher Education	270.8
General Government	28.2
Total	1,369.7

We have long believed that the cost of state programs can be reduced by contracting for certain services with the private sector. In fact, in our *Analysis of the 1980–81 Budget Bill,* we recommended that the Legislature submit a constitutional amendment to the voters that would authorize the procurement of government services using independent contractors whenever it can be shown that the costs would be less than using state employees. We are the first to admit, however, that contracting does not make sense in all cases. Generally, it makes sense *only* if it is the more cost-effective alternative for providing a given level of service, or if there are special circumstances that warrant it, such as a lack of expertise in a department to perform a particular task.

This section analyzes the themes of the Governor's new personal services contracting proposals, and identifies the criteria that we believe the Legislature should use in evaluating these proposals.

Background

During the fall of 1984, the administration established a task force to review proposals for expansion and nontraditional uses of contracting out for personal services. Departments were not required to submit to the task force contracting proposals which essentially were continuations of past contracting practices. Proposals that were not submitted to the task force instead were reviewed by the Department of Finance prior to inclusion in the budget.

The task force requested that the following information be submitted with each proposal:

- The benefits of contracting out the work.
- A cost analysis of the contracting option versus current services, or for new activities, the projected costs if the work were performed by civil service employees.
- The data or background information needed to determine compliance of the proposal with contracting restrictions included in state law.
- The potential impact of the proposal on existing personnel (layoffs, for example).
- The likely impact of the proposed contract on quality of services.

The Administration's Proposals

The budget's new personal services contracting proposals generally fall into one of the following four categories:

- Contracts for functions *currently performed* by state employees.
- Contracts for *new functions.*
- Contracts where *additional* workload will be contracted out while *existing* workload continues to be performed by existing state staff.
- Contracts which *transfer* work currently performed by the state to another level of government, or another governmental entity.

In some instances, a contract may fall into more than one category. Examples of proposed contracts in each of these categories are listed below.

1. Contracts for functions currently performed by state employees.

- The *Department of Education* is proposing to spend $158,000 in 1985–86 to contract with other state agencies or private firms for the performance of unspecified, routine data processing tasks currently performed by the department's Education Data Management Systems division. This, in turn, will allow existing staff to undertake new projects related to the automation of school apportionment mechanisms.
- The *Museum of Science and Industry* proposes to eliminate 11.8 temporary-help personnel-years and contract ($265,000) for parking lot operations.
- The *Department of General Services* proposes to avoid hiring 69.3 personnel-years to provide janitorial and maintenance services in two new state office buildings. The money it would take to hire state personnel ($1.7 million) will be used to contract for the service instead.

2. Contracts for new functions.

- The *Department of Commerce's* California Film Office, established by Ch 1639/84, issues permits to filmmakers who wish to utilize state properties or facilities in commercial films. The department proposes to enter into a $40,000 contract to perform this activity in the budget year.
- The *Department of Health Services* proposes to contract for $1 million of laboratory work related to implementation of the Hazardous Substances Bond Act of 1984 passed by the voters in last November's General Election. The department also proposes to spend in excess of $3.5 million for a contract to develop drinking water standards. This proposal also includes funds to contract out the state's traditional function of contract management.

3. ***Contracts where additional workload will be contracted out, while existing workload will continue to be performed by existing state staff.*** The most common contracts of this type relate to janitorial services.

- The *Department of Parks and Recreation* uses state employees to provide janitorial and maintenance services at the Lake Perris State Recreation Area, but will contract for janitorial services at a new visitor center which will open in the area in 1985–86.
- The *California Highway Patrol* and the *Department of Motor Vehicles* have janitorial services contract proposals which together will result in the reduction or avoidance of approximately 67 personnel-years.
- The *State Library* will spend $56,000 on a contract to extend the Sutro Library's operating hours.
- The *Student Aid Commission* will undertake additional audits on a contract basis.

4. ***Contracts which transfer work currently performed by the state to another level of government or another governmental entity.*** The primary examples of transfers to another level of government occur in the health and welfare area.

- The *Department of Health Services* proposes to spend $841,000 to contract with county environmental health inspectors who would be on loan to the state for one year to enforce state and federal hazardous waste laws.
- The *Employment Development Department* proposes to contract ($7.4 million) with local training agencies throughout the state to provide job service activities.
- The *Department of Rehabilitation* is proposing to spend nearly $11 million on contracts with nonstate rehabilitation providers. The proposal consists of two components. The first component utilizes $6.6 million to fund rehabilitation services that will be provided to disabled students by local school districts and community colleges. The second component consists of $4.0 million, which the department will use to purchase services from other public or private rehabilitation providers.
- The *State Personnel Board's* Local Government Services Program traditionally has performed merit system and technical personnel services for local governments on a fully-reimbursable basis. The budget proposes that these services be provided, instead, through a Joint Powers Authority governed by local government officials and representatives of the board. The proposal allows the budget to show the elimination of all 55.4 personnel-years associated with the program.

- The *Department of Transportation (Caltrans)* has traditionally employed graduate and engineering students. The budget proposes, instead, to contract with California State University (CSU) for $959,000 to hire students (approximately 61 personnel-years) on a contract basis. This staffing level would not be reflected in either Caltrans' or CSU's personnel-year totals.
- The *state hospitals and the Veterans' Home* traditionally have utilized their own laundry facilities and staff (104 pys on a full-year basis) to launder residents' clothing. The budget proposes to contract ($1.5 million) with the Prison Industry Authority (PIA) to perform this function in the budget year. Because the contract will be phased in during 1985–86, the budget shows a reduction of 60 pys related to this proposal.

Cost Impacts of the Administration's Proposals

Our analysis indicates that the administration's contract proposals can be divided into three categories with respect to their cost implications—contracts that would cost the *same* as having state employees do the work, contracts that would cost *less* than the amount required to hire state employees, and contracts that would cost *more* than comparable services provided by state employees.

Equivalent Costs. Our analysis indicates that the amount of funding requested in the budget for nearly half of the more than 100 new personal services contracts was based on the costs of having state employees do the work. The $1.7 million contract for janitorial services that is funded in the *Department of General Services'* budget is a typical example of this equivalent-cost contracting. The same can be said for the $11 million contract for vocational rehabilitation services in the *Department of Rehabilitation* and the $7 million contract for job services in the *Employment Development Department.*

Cost Savings. Based on information currently available to the Legislature, we have been able to identify only two instances in which the administration's new contracting proposals will result in cost savings. The *Department of Motor Vehicles'* proposals to contract out for janitorial and key data operator services are estimated to save approximately $260,000 in 1985–86. This money has been deleted from the department's budget. Similarly, the *California Highway Patrol's* proposals to contract out for janitorial services should save approximately $397,000 in the budget year. These funds have been redirected, however, to fund other activities within the department.

Cost Increases. On the other hand, a number of the Governor's proposals will result in increased costs to the state. The *Energy Commission,* for example, is requesting $360,000 for a contract to analyze a backlog of energy use survey data. If the commission hires graduate student assistants to perform this task, as it has done in the past, the state could save $257,000. Similarly, the *Department of Food and Agriculture* proposes to contract with six counties for highway inspections of fruit and vegetables to assure that they meet specified quality standards. If state staff did the work, it would cost $138,000 less. The *Air Resources Board* also is proposing two contracts because its existing staff is either insufficient or too busy to do work related to (1) the development of control measures for air pollution and (2) the improvement of emission inventory estimates. The state could save $385,000, however, if state staff instead were hired to do this work.

Potential for Future Increased Costs Due to Contracting. Our analysis indicates that what may be presented as equivalent costs this year may turn out to be increased costs once the state department puts the contract out to bid.

For example, in the 1984–85 Governor's Budget, the *State Fire Marshal* proposed a contract of $298,000 to expand the office's fireworks program. The amount proposed was based on the office's estimate of what it would cost if in-house personnel were used. The State Fire Marshal assured the Legislature that the program contained in a draft request for proposal could be implemented fully within the requested amount, and with these assurances, the Legislature appropriated the full $298,000 requested in the budget. One year later, our analysis indicates that the costs in the current year for doing *less* than what originally was proposed is now nearly 12 percent higher.

Whether or not the administration encounters cost overruns in attempting to let the new contracts proposed in the budget, these contracts may prove more difficult to implement than it may appear. This is because the state has had limited experience with the type of expanded personal services contracting envisioned in the Governor's Budget for 1985–86. Consequently, implementation delays and narrowing of program scope could have a potentially significant impact on services as well as costs.

Impact on Services

Due to the lack of detailed information regarding how various contracts actually would be implemented, it will be difficult for the Legislature to identify the effect that many of these proposals will have on state services. For example, the *Employment Development Department's* proposal to contract with local training agencies to provide job service activities does not make clear what activities actually will be funded. As a result, we cannot determine the impact this contract would have on training services for the unemployed.

Similarly, the *Department of Rehabilitation's* proposal to eliminate field office staff and provide vocational rehabilitation services with nonstate providers may have a significant impact on disabled clients. As discussed in the *Analysis,* it is not clear that the proposed change will buy as much service as the state employees being replaced could provide. To the extent that it costs more to provide services to each client on a contract basis, fewer clients will actually receive services.

In order for the Legislature to evaluate the new personal services contracting proposals, the administration must provide sufficient data to permit an evaluation by the Legislature of the impact that the contract would have on the quality and quantity of services provided by the state. As discussed in detail below, this information, as well as other necessary documentation, had not been submitted at the time that this analysis was prepared.

More Documentation Needed

Based on our review of the supporting documentation accompanying the new personal services contracting proposals and discussions with the Department of Finance, we conclude that many of the approximately 100 contract proposals are still in the conceptual phase of their development. The administration simply has not met *its own* informational requirements, as set forth in a December 3, 1984, memorandum to agency secretaries and departmental directors. Specifically, for a large number of proposals, adequate information has not been provided on:

- The specific work to be contracted out;
- The cost impact of the contracting proposal in comparison with projected state costs using state employees to provide the service;
- The extent to which the contracting proposal complies with existing state law; and
- The impact of the contract on the quality of services provided.

As a general rule, supporting documents assert that the proposal is "efficient," "cost-effective," "legal," and "will not reduce the quality of services," but substantiating analysis and documentation of these assertions are often lacking.

This approach poses significant problems for the Legislature, since it will have to pass on the contract's appropriateness relative to the use of state employees, while the contracting proposal is still being developed. For this reason, we have recommended throughout the *Analysis* that the administration provide the Legislature with additional information concerning these contracting proposals.

The first step in ascertaining the viability of these proposed contracts should be an analysis to determine if the contract complies with the requirements of existing state law. It is to these legal requirements that we now turn.

Existing Law Governing Contract Services

Case Law. The California Supreme Court, in three decisions (dating back to 1937), has limited the ability of the state to use private contractors to perform state government support services. These decisions have been based largely on the presumption that the civil service, as established in the California Constitution (Article VII, Section 1), should perform most, if not all, state governmental functions.

Statutory Law. Chapter 1057, Statutes of 1982 (Government Code Sections 19130–19132), sets guidelines for state contracting of personal services. These guidelines essentially codify those established prior to 1982 by the State Personnel Board. The board based these contracting rules on the court decisions mentioned above. By enacting Chapter 1057, the Legislature apparently intended to clarify—and give more legal weight to—the rules governing contracting for services.

As specified in Chapter 1057, the general instances under which personal services contracting is *permissible* include the following:

- The service is not available within civil service (for example, the expertise of a private research consultant);
- The service is part of a new state function involving work authorized by the Legislature (for example, the translation of election materials into certain foreign languages); or
- The service is urgent, temporary, or occasional in nature, and timely delivery of the service is critical (for example, the use of private reporters and transcribers to handle peak workload for agencies which conduct administrative hearings).

Chapter 1057 also sets forth the specific conditions that govern personal services contracting to achieve *cost savings.* These conditions, *all* of which must be met, are as follows:

- The contractor has demonstrated that the proposed contract will result in savings;
- The savings are large enough to account for normal cost fluctuations and justify the size and duration of the contracts;
- The economic risk to the state from potential rate increases is minimal;
- The contractor's wages do not significantly undercut state pay rates;
- The contract does not cause the "displacement" (layoff, demotion, or involuntary transfer) of civil service employees;
- The contract satisfies the state's affirmative action standards; and
- The potential economic advantage of contracting is not outweighed by the public's interest in having a function performed directly by state government.

Summary. Case law regarding state contracting places the burden of proof on those agencies seeking to contract out state work. Recent legislation (Chapter 1057), however, suggests to us that the Legislature is willing to *expand* the practice of contracting for services, especially where potential cost savings are involved. It is hard to reconcile completely the cost-based contracting provisions of Chapter 1057 with a 1937 California Supreme Court decision which prohibited the consideration of economy or efficiency as a primary reason to contract out.

This legal question, as well as others, are likely to be tested in court. In fact, the California State Employees Association (CSEA) has recently challenged state personal services contracting proposals. Specifically, it has challenged the Employment Development Department's current efforts to contract out janitorial work in three of its field offices. Similarly, the state has been sued by the Professional Engineers in California Government regarding a Caltrans proposal to contract with private firms for certain design, materials testing, and other construction-related activities currently handled by state engineers. A suit also has been filed challenging the State Energy Commission's contract with a private firm to review proposed energy facility sites. The Legislature and the administration need to evaluate the risks of pursuing contract proposals that fall into legal gray areas. Such contracts may result in increased liabilities for the state.

What Criteria Can the Legislature Utilize to Evaluate These Proposals?

In order to evaluate the multitude of contracting proposals included in the Governor's Budget for 1985–86, the Legislature needs to assure itself that the administration can justify the proposal on a cost-savings, programmatic, and legal basis. The Governor's task force, in specifying the information it needed to evaluate contracts, outlined five of the criteria which we believe should be considered by the Legislature:

- Does the proposal conform to existing legal requirements?
- Are the estimated contract costs reasonable and verifiable? Is it cost-effective?
- What is the potential personnel impact (layoffs, transfers) of the proposal? Is the contract proposed simply as a substitute for using state personnel, rather than to achieve cost-savings or to improve program effectiveness?
- Is the contract service of equal or comparable quality to the same service if performed in-house?
- What benefits will the state derive from contracting?

In addition, we believe there are three other criteria the Legislature also should consider.

- Could short-term savings be offset by additional, unanticipated long-term contracting costs?
- Does the contract pose policy considerations by calling for identical

work to be performed by both contract and state personnel in a single program?

- Will the state be vulnerable or liable if the private contractor unexpectedly is unable to deliver the service?

Conclusion

The Governor's Budget contains a number of proposals to contract out personal services—many of which are innovative and nontraditional. Some of these proposals may well provide a means for delivering services or performing essential tasks at less cost to the taxpayer.

Unfortunately, many of the approximately 100 new personal services contracts are not well-defined and remain in the conceptual phase of their development. We suspect that this is because the decision to contract was based on the effect it would have on the size of the state's work force, rather than on a determination that this approach would be cost-beneficial or result in better delivery of services. As a result, in a significant number of cases, the Legislature has not been provided the information it needs in order to determine the contract's reasonableness, cost/benefit, or effect on the quality of service provided to the public.

Because these proposals have not been developed fully, the Legislature is placed in a position of trying to make the Governor's Budget whole. This, however, is appropriately the responsibility of the administration. The administration needs to determine the viability of its own proposals before deliberations on them can proceed.

THE CONDITION OF THE STATE'S INFRASTRUCTURE

What Can be Done to Facilitate the Legislature's Ability to Address the Need to Maintain and Expand the State's Infrastructure System?

What is Infrastructure?

There are many definitions of "infrastructure." For the purposes of this discussion, we have defined the term to mean investment in physical facilities. Investment in this context includes not only construction of new facilities, but also (and not secondarily) the alteration, repair and maintenance of existing assets.

In order to establish a statewide strategy to improve and sustain the state's infrastructure, the Legislature should consider the infrastructure system *as a whole*, rather than as individual elements or projects. In this way, the condition of the state's infrastructure can be identified in a manner which allows the Legislature to assure that these interrelated, yet competing, systems will serve the needs of the people of California, now and in the future. Unfortunately, the state's current capital outlay budget structure does not facilitate this type of review.

This section analyzes the administration's budget proposal for addressing the state's infrastructure needs, and makes recommendations for facilitating the Legislature's ability to act on the proposal and go beyond it.

The Condition of the State's Infrastructure Systems

Compared to eastern states, California has relatively new public facilities. Moreover, in most areas of the state, California is fortunate to have moderate weather conditions which extend the life of physical facilities. As a result, the deterioration of the state's infrastructure has not, in most cases, reached a crisis point. To avert a crisis in the future, is the challenge which the Governor and the Legislature now face.

Two studies of California's infrastructure were completed in 1984.

The Assembly Office of Research (AOR) completed a study in January 1984 which focused on "intrinsic infrastructure." This term was defined to include "eight infrastructure systems without which other vital public services and private commerce could not function—state highways, county roads, city streets, public transit, sewage systems, water systems, solid waste management, and flood controls/drainage systems." The AOR's report concluded that, during the next decade, there would be an estimated $24 billion funding shortfall for these systems under current policies.

The Governor's Infrastructure Review Task Force investigated a wider range of infrastructure than did the Assembly Office of Research. The task force defined infrastructure as the state's collective network of facilities (including maintenance) and divided it into three categories:

1. Intrinsic infrastructure (streets, highways, utility systems, etc.);

2. Protective infrastructure (police/fire facilities, prisons, hospitals, etc.); and

3. Enriching facilities (educational facilities and parks).

In April 1984, the task force reported that during the next decade, approximately $29 billion will be needed for deferred maintenance and $49 billion will be needed for new infrastructure. The task force indicated that ". . . while funding for some of these needs are already in place, an estimated $51 billion shortfall exists." The components of the $51 billion shortfall are shown in Table 52.

The financing shortfall identifed in these two studies reflects the estimated funding requirements for (1) eliminating deferred maintenance, and (2) meeting rehabilitation and expansion needs over the next decade. It is important to note that the identified needs and associated cost estimates were supplied by the affected entities themselves, and therefore may be biased in an upward direction. Nevertheless, the general magnitude of California's infrastructure financing needs certainly falls within the range identified in these two studies.

Table 52
Estimates of Ten-Year Funding Shortfalls for California's Infrastructure Compiled by the Governor's Task Force on Infrastructure Review [a]
(dollars in millions)

	Total Needs	*Estimated Funding*	*Funding Shortfall*
State-Supported Facilities			
State-maintained highway system	$26,500	$11,400	$15,100
State water project	1,268	1,268	—
State Universities	772	486	286
University of California	2,509	870	1,639
State hospitals	125	125	—
State prisons	2,135	600	1,535
State/Local-Supported Facilities			
Local streets and roads system	6,900	2,780	4,120
Bus and rail transit	9,600	728	8,872
Air carrier/commuter airports	1,600	1,600	—
General aviation airports	420	410	10
Domestic water systems	850	30	820
Wastewater treatment	12,500	406	12,094
Flood control and drainage	579	250	329
Solid waste disposal	3,000	3,000	—
Elementary and high schools	4,800	1,350	3,450
Community colleges	480	290	190
Local jails	2,700	—	2,700
Parks and recreation	250	250	—
Government buildings	633	633	—
Totals	$77,721 [b]	$26,576 [b]	$51,145

[a] Source: Infrastructure Report and Recommendations, April 15, 1984—Governor's Infrastructure Review Task Force, State of California. Figures based upon current revenue and taxation structure.
[b] We are unable to reconcile the difference between the detail and the estimated totals.

Recommendations Made by the Governor's Task Force

The report issued by the Governor's Task Force contained a series of recommendations for dealing with the infrastructure problem. Some of the task force's more important procedural and policy recommendations called for the state to:

- Initiate long-range strategic planning in each infrastructure element at the state level. This would set forth broad goals and objectives for meeting future statewide needs.
- Establish, as state and local government's highest infrastructure priority, the elimination of deferred maintenance.
- Establish the rehabilitation of existing facilities, and the construction of new infrastructure, as the state's next highest priorities.
- Terminate the practice of balancing budgets by deferring maintenance of infrastructure.
- Establish a separate, identifiable program in the Governor's Budget

that would include all major capital outlay proposals for the pending fiscal year.

- Establish a five-year capital outlay budget.
- Require each ensuing year's capital outlay budget display to identify the progress which has been made to reduce deferred maintenance backlogs.

Governor's Program For Rebuilding California

The Governor's Budget for 1985–86 (page 50) identifies a "Program for Rebuilding California." This program displays $25.1 billion in expenditures that will be made over the six-year period from 1984–85 through 1989–90. Most of these funds ($23.6 billion) would be expended under provisions of existing law, and, therefore, do not represent new funding to address the state's infrastructure needs.

The portion of the program that does reflect new funding, totaling $1.5 billion, consists of:

- $700 million from anticipated settlements of tidelands oil litigation and offshore oil negotiations;
- $650 million for local bond pooling to finance capital projects;
- $125 million for "privatization" (utilization of private-sector resources) in areas previously reserved for public entities.

Tidelands Oil Litigation. In 1975, the state and the City of Long Beach sued the consortium of oil companies (known as THUMS) that produce oil on state lands in Long Beach. The suit alleges that THUMS conspired to fix oil prices that were the basis for payments to the state/city for oil produced from 1962 through 1977. The state is seeking damages of up to $300 million, which could be tripled under antitrust law. In December 1984, the state settled with one of the companies for $21.5 million. This amount is included in the balance available for appropriation in the Special Account for Capital Outlay.

Offshore Oil Revenues. The federal Outer Continental Shelf Lands Act calls for the federal government to share with the relevant coastal state the revenue it derives from oil and gas operations conducted three to six miles offshore. The Department of Interior must deposit revenues from development of these resources off each state's coast into an escrow account until a sharing agreement has been reached with the Governor. The escrow account now contains approximately $1.6 billion in revenues from lands off the California coast.

In August 1984, the Department of Interior offered California nearly 17 percent (approximately $267 million) of the escrow amount, with the stipulation that California would *not* receive any future royalties. It is our understanding that negotiations with the Department of Interior are continuing, and that the state has neither accepted nor rejected this offer.

Local Bond Pooling. The Governor proposes a program under which local governments could realize "economies of scale" in raising money for infrastructure by "pooling" their debt issues. By issuing a few larger bonds in place of many smaller bonds to finance local projects, local agencies should be able to improve the marketability and reduce the costs of their debt issues. This portion of the Governor's program would require enabling legislation.

Privatization. Privatization envisions a partnership between the public and private sectors. The public sector receives the benefit of a facility without putting up the initial development cost, while the private sector secures profits and receives tax/investment credits by putting up the initial capital for the project. This concept is particularly suited to infrastructure elements that yield a regular income and are equipment-intensive. These elements would, for example, include waste water treatment, solid waste disposal, and hydroelectric facilities. This concept may also require legislation to allow such partnerships.

Analysis of the Governor's Infrastructure Program

We believe the Governor is to be commended for identifying, as a separate long-term program, the state's infrastructure needs. To our knowledge, this is the first time infrastructure has been separately addressed in the budget. Thus the Governor has taken an initial step toward facilitating legislative consideration of infrastructure improvement needs.

The Governor's program, however, is deficient in two key respects. First, it does not address the funding shortfalls identified in both the AOR's study and the report submitted by his own task force. Nearly 95 percent of the $25.1 billion that the budget "identifies" for meeting infrastructure needs would be spent under current policies—the policies that have been identified as insufficient to meet the state's needs. The main source of *new* funding, moreover, is at this point, far from certain.

The Governor is to be commended for advising the Legislature of his spending priorities for the $700 million in revenue that *may* be received from tidelands oil litigation and offshore oil negotiations, in advance of their being received (priorities include local streets and roads, cleanup of toxic sites, deferred maintenance at state-owned facilities, and construction of two prisons). Given the uncertain outcome of the litigation and negotiations, however, there is no basis for establishing either the amount or timing of any revenue that will be realized from these sources.

In sum, the first six years of the Governor's "Program for Rebuilding California" is basically a status quo program.

Second, the Governor does not propose any action to implement the recommendations made by his own task force. In our judgment, these recommendations would go a long way toward improving both the executive's and the Legislature's ability to oversee the financing of and progress made in addressing the state's infrastructure needs.

For example, the task force recommended that the budget include all major capital outlay proposals in a separate program, and display expenditures under this program for the next five years. This would provide the Legislature with a clear picture of the overall infrastructure program and facilitate meaningful legislative review of it. The Governor's Budget displays an overall broad program which lacks the specificity envisioned by the task force.

The task force also recommended that deferred maintenance be designated as the state's highest funding priority. The budget does not implement this recommendation. Nor does it contain the information that would permit the Legislature to implement this policy. In fact, it is difficult, at best, to identify in the budget those funds that are proposed for maintenance, special repairs, and other infrastructure-related items. Although these funds are separately displayed in the budgets for the University of California and the California State University, for most other departments they are simply lumped together in a single line item—"facility operations"—which includes funds for utilities and other costs that are not directly related to maintenance of infrastructure.

In addition, the task force recommended that (1) the rehabilitation and deferred maintenance allocation in each departmental operating budget be linked to the overall five-year capital budget plan and (2) each ensuing year's capital display identify progress in reducing the deferred maintenance backlog. This is an essential component for assuring that priority needs are funded and the amounts appropriated are spent as intended by the Legislature. Again, there is no indication in the Governor's Budget that this aspect of the task force's recommendations will be implemented.

In view of the pending shortfall in funding for needed infrastructure that now seems to be beyond contention, it is incumbent on the administration to advise the Legislature of its plans to address this shortfall. We also believe it is incumbent for the administration to address the recommendations made by the Governor's Task Force.

Recommendations for the Legislature's Consideration

As the Legislature awaits a complete program for meeting the state's infrastructure needs from the Governor, we believe there are several interim steps that the Legislature can take that would facilitate its ability to address the need for maintaining and expanding the state's infrastructure. Accordingly, we recommend that the Legislature:

- Identify funding for various elements of infrastructure, by line item, in the Budget Bill, and adopt budget language restricting the transfer of these funds for other purposes.

- Direct the administration to submit annually a five-year capital outlay budget.
- Set priorities for renovation, new construction, and increased maintenance of state facilities.
- Establish standards for appropriate maintenance of state facilities.
- Establish, as a high-priority goal, the elimination of deferred maintenance.
- Require departments with a responsibility for infrastructure elements to establish a preventive maintenance program.

We also recommend that the administration:

- Identify (1) the condition of the state's infrastructure on a department-by-department basis and (2) the current maintenance level of departmental facilities.
- Submit to the Legislature an annual post-audit report, identifying what has been accomplished with infrastructure funding provided in the annual Budget Act.

By taking these types of steps, the Legislature will be able to consider the infrastructure system as a whole and assure that these systems serve the needs of the people of California.

INFORMATION TECHNOLOGY APPLICATIONS FOR STATE OPERATIONS

How Can the Legislature Assure that the Automation Projects Proposed in the Budget are Soundly Conceived and Implemented?

During the last two years, the State of California has made a major effort to increase employee productivity through the use of modern information technology. Many agencies have replaced manual processes with automated systems; many others have begun to install office automation systems. Examples of large-scale information technology projects either underway or proposed for the budget year include (1) major office automation projects in the Department of Social Services and the Judicial Council, (2) enhanced telecommunications within the Department of Motor Vehicles and the California Highway Patrol, (3) information system projects within the Employment Development Department, and (4) replacement of large computers in the Board of Equalization.

Although no precise statistics are kept on state expenditures for information technology, the Governor's Budget estimates that the level of these expenditures proposed for the budget year exceeds $500 million. This, the budget estimates, is $45 million, or approximately 10 percent, above the current-year level.

Potential Benefits from Automation

Obviously, the use of modern information technology holds the potential to both reduce the cost of state government and improve the quality of services that the state provides. Many agencies are in the process of realizing these potential benefits. For example, automation projects are expected to result in savings of at least 475 personnel-years during the budget year, in four agencies or program areas alone: the Department of Motor Vehicles (175), the Employment Development Department (163), the state hospitals (105), and the Department of Social Services (32). Other automation proposals, such as the Board of Equalization's computer replacement project, will make existing programs more effective, regardless of whether they yield savings.

Automation Proposals Are Not Automatically Sound

While automation proposals offer the possibility for significant benefits to the state, they also carry with them large risks:

- The risk of large cost overruns;
- The risk that automation equipment either will duplicate or be incompatible with existing equipment;
- The risk that information systems will not work properly;
- The risk that information systems will work properly but fail to provide useful information; and
- The risk that automated systems will prove to be incompatible with programmatic objectives.

Perhaps the best example of how an automation project can go awry is the Statewide Public Assistance Network (SPAN) project, which was initiated in 1979–80 to assist in the delivery of benefits to various public assistance recipients. The project never became operational, despite the expenditure of *$19 million* (all funds), and was terminated in July 1982. There were many reasons why the project failed to yield any benefits to the state, not the least of which was the state's failure to plan the project effectively in both the long and short term. Specifically, the project never defined an appropriate system for the task at hand and presented three separate approaches in a 12-month period, *each* of which was labeled as the most cost-effective alternative. As these difficulties developed, projected expenditures increased and prospective savings grew increasingly uncertain.

Given the risks attached to automation projects and the amount of money at stake, the Legislature needs to carefully review those automation projects for which the budget requests funds.

Requirements for Success of an Automation Project

There exists no single approach that will assure the success of an automation project. Our analysis indicates, however, that several factors can improve the probability that an automation project will succeed. These prerequisites for success are as follows:

1. The department undertaking the project has a *strategic plan;*
2. Departmental *management is involved* in the project;
3. Departmental *users are involved* in the project;
4. A rigorous *feasibility study report* has been prepared and reviewed;
5. The department has *adequate staff* to carry out a project; and
6. A *pilot project* precedes full-scale implementation.

1. Strategic Plan. The State Administrative Manual *requires* that a feasibility study report be completed for most individual automation projects. Strategic planning of a department's overall information technology needs, however, is essentially an *optional* exercise. Nevertheless, it is important for each department to (a) develop a clear sense of direction for its programs, (b) develop an overall architecture for its information technology systems that is consistent with programmatic direction, and (c) assure that individual projects are consistent with both programmatic direction and system architecture. This approach was followed successfully last year by the Department of the Youth Authority, when it completed a comprehensive review of its automation needs. Similarly, the State Treasurer's Office currently is undertaking a thorough strategic planning effort that has the potential to increase the benefits from future investment in office automation.

In contrast, the Employment Development Department (EDD) is proceeding to automate a manual system *without* having first addressed the underlying program objective. The department is automating its job sharing system so that individuals seeking employment will have greater access to job openings in different geographical areas. This project, however, fails to take into account the fact that there already are sufficient applicants for existing job openings. The key problem facing those without jobs—a shortage of job openings—will not be ameliorated by the project. The Legislature recently addressed the need to strengthen the EDD's planning efforts by enacting Ch 1226/84 (AB 1654), which requires EDD to develop a strategic plan for all of its automation efforts.

2. Management Involvement. It is the responsibility of departmental management to assure that strategic planning occurs, and that each individual project developed is consistent with overall departmental goals and information processing architecture. The redesign of the Franchise Tax Board's personal income tax system and the Public Employees' Retirement System's automation project are two examples of projects that were successfully implemented, partly because of top-level management involvement. In each case, the project manager reported directly to the department's executive officer. Conversely, the Hazardous Waste Information System developed by the Department of Health Services has not been successful, in large part because system development efforts were not coordinated with departmental planning. This problem possibly could have been avoided had departmental management taken a more active interest in the project. Similarly, the Department of Consumer Affairs' distributed data processing project failed, at least in part, because it lacked sufficient top-level management involvement.

3. User Involvement. The success of many projects also is determined by the extent to which the ultimate users of the system are involved in its design. Data processing staff must understand the processes that are being automated, who will use the information, and how it will be used. In addition, early involvement of users is much more likely to assure their support of the new system once it is put in place. The California Fiscal Information System (CFIS), which has cost over $45 million to develop, failed in both its conception and design to account for the ultimate needs of its users. As a result, the central fiscal data base envisioned for the system rarely has been used, and two major components of this data base have been eliminated.

In contrast, the State Controller's Office established a user committee during the early stages of its current office automation project. This committee was responsible for determining the needs that would be served by the system. Implementation of the Department of Motor Vehicles' field office automation project also was characterized by a high level of user involvement.

4. Feasibility Study Report (FSR). The Office of Information Technology (OIT) requires and reviews an FSR for almost all proposed large automation systems. Creating an FSR does not, in and of itself, assure the success of an automation project. An FSR which *rigorously* identifies problems, specifies needs, addresses realistic alternatives, and assesses costs and benefits is much more likely to lead to a successful project. The FSRs prepared by many departments—for example, those prepared for the Department of Justice's Automated Child Abuse System and the State Controller's office automation system—exhibit this type of rigorous planning.

This was not the case, however, with the feasibility studies developed by the Employment Development Department (EDD) to support its unemployment insurance and disability insurance program automation proposals. Our analysis of these FSRs indicates that they do not adequately assess alternatives for setting up the system. In fact, the various FSRs prepared by EDD (a) discuss only the recommended alternative, (b) reject alternatives without explanation, and (c) rarely quantify benefits associated with alternatives. Without this type of information, it is difficult for anyone, in particular the Legislature, to be confident that the alternative chosen is the most cost-effective solution to a problem.

5. Staffing. Successful implementation of an automated system requires both adequate staffing and the proper mix of experienced and skilled technical personnel. Unfortunately, there currently is a shortage of such personnel in the state. One of our initial concerns regarding the SPAN project, for example, was that because there existed a serious shortage of qualified electronic data processing professional staff in state government, the Department of Social Services would experience difficulty in hiring an adequate number of skilled personnel for the project. Similarly, one of the reasons that the Department of Mental Health's Patient Care System has encountered difficulties is that the department has been unable to retain adequate levels of skilled personnel on the project.

On the other hand, the Department of Housing and Community Development, in redesigning its registration and titling system, followed suggestions made by OIT and redefined both its staffing levels and the mix of position types assigned to the project. This project appears to be successful, in part, because the staff necessary to carry out the project was put in place at an early stage.

6. Pilot Projects. A pilot project is a scaled-down version of a full automation project. It often is conducted within a subset of the areas that will be served by the full project—a regional office, or an office within a department—and is used to simulate the system as a whole. The pilot approach provides workload information which makes it possible to develop a realistic assessment of computing equipment requirements and other resource needs for the full system. Once again, our review of SPAN indicates that its chances of success might have been improved had a pilot project been undertaken to provide this type of information. Pilot projects have been used successfully in many instances, including the Medi-Cal Eligibility Determination System in the Department of Health Services. The Department of Social Services currently is overseeing the Food Stamp On-line Issuance System pilot program, which appears to be very successful.

Importance of the Office of Information Technology

Chapter 1327, Statutes of 1983 (AB 2074), made the Office of Information Technology (OIT) in the Department of Finance reponsible for statewide advocacy, planning, and policy setting in the area of information technology. OIT also is responsible for review and control of departmental plans and projects. (OIT's role is discussed more fully in our review of the Department of Finance's budget.)

In light of both the Legislature's mandate and the state's emphasis on increased automation, OIT's role is pivotal in assuring the success of automation projects and the wise use of statewide information technology resources. The OIT has taken some significant steps in its new role as advocate and statewide planner, and continues to perform a valuable service to the state in its traditional project review role. Our analysis indicates, however, that OIT could strengthen its effectiveness in both of these areas.

Statewide Planning and Analysis. The OIT has become much more active in advocating the use of information technology within the state. It also has developed various policies, such as a draft policy for purchasing microcomputers, and a draft revision of State Administrative Manual (SAM) guidelines related to information technology. Our analysis indicates, however, that the state continues to lack plans and policies in several areas such as office automation and the role of state data centers.

State policies in areas such as these would improve the ability of departmental managers to make informed decisions about information technology projects. This is particularly true in the area of office automation. Many managers don't understand the potential benefits of office automation and are not aware of the problems inherent in purchasing non-compatible equipment and software. The Department of Justice (DOJ), for example, proposes to spend $2 million in the budget year to implement an integrated office system. DOJ also is budgeting $438,000 to replace, upgrade, or expand *existing* word processing systems which are not compatible with its new system. The state needs to adopt policies which discourage duplicative and counterproductive proposals like this one.

In addition, our discussions with OIT staff and our review of its plans and policies indicate that OIT needs to devote more effort to policy *analysis.* By this, we mean additional discussion of statewide information technology objectives, problems limiting the achievement of those objectives, and alternatives to solving those problems. Specifically, OIT needs to address more forcefully:

- ***What are the ultimate goals of automation?*** To increase worker productivity? To provide information?
- ***What are the problems that keep the state from consistently achieving these goals?*** Poor project planning? A shortage of qualified personnel?
- ***How can the state solve these problems?*** Adopt policies to assure management and user involvement? Use new technology to reduce project backlogs? Increase the involvement of state or private sector consultants?

Additional critical analysis to support the policies that OIT has developed or is drafting would assist the state in solving the problems that cause information technology projects to fail.

Plan Review and Consulting Staff. The OIT has been charged with its new policy development role for only one year. Therefore it is understandable that many important plans and policies have not yet been implemented. It is more difficult to understand why the level of staff in OIT devoted to reviewing plans and projects—its traditional role—has not kept pace with the dramatically increasing workload. Between 1982 and 1984, OIT's workload more than doubled, while OIT's review staff decreased slightly. As a result, the number of projects that OIT does not review is on the rise.

OIT has begun to provide consulting support to state agencies that are preparing strategic plans and feasibility studies. This service is particularly crucial for those small- and medium-sized departments with little or no information technology expertise. Once again, however, our analysis indicates that the amount of consulting staff available is not adequate to meet the need for consulting services.

Guidelines for Legislative Deliberations.

By establishing as a high-priority goal the increased use of automation statewide, the administration is working to increase efficiency and productivity in state government. The Legislature, however, cannot assume that these benefits will be forthcoming from the projects proposed for funding in 1985–86. As a consequence, the Legislature, in considering individual funding requests for proposed automation projects, should confirm that:

- Departments have at least begun the process of developing a strategic plan for use of information technology *prior to requesting funding for individual projects,* and will have such a plan in place within a reasonable time;
- Departmental management and users are sufficiently involved in automation projects, and that departmental policy and management objectives are being considered in developing feasibility studies;
- Sufficient staffing has been provided to departments for the implementation of proposed projects.

Finally, the Legislature needs to assure itself that sufficient staffing resources have been provided to the Office of Information Technology so that it can (1) analyze and propose solutions to information technology problems, (2) quickly develop statewide plans and policies, (3) adequately review feasibility studies and strategic plans, and (4) provide necessary consulting support to state agencies.

REGULATION OF FINANCIAL SERVICES

Does the Legislature Have Sufficient Information to Determine Whether the State's Financial Regulatory System Should be Modified in the Face of Marketplace Changes Resulting from Deregulation?

For many years, financial institutions survived and profited in a very heavily regulated and stable marketplace. Banks, savings and loan associations, and credit unions were designed to serve different segments of the marketplace, and the federal and state regulatory structure evolved along these lines.

The industry changed during the latter part of the 1970s. Brokerage firms that offered money market accounts paying interest on a par with other market investments began draining billions of dollars in depositors' funds from the financial institutions.

Starting in 1980, Congress and many states acted to ease the plight of financial institutions through a series of steps designed to deregulate their activities. Deregulation effectively authorized banks, savings and loans, and credit unions to pay market interest rates on certain accounts and to increase interest rates significantly on other accounts. California went one step further by granting broad new investment authority to its financial institutions.

As a result of the dramatic changes which have taken place in the financial services marketplace, the state's financial institutions now are subject to a complex jurisdictional web of seven federal regulatory agencies and five state agencies. At a time when the marketplace is moving to a distribution of financial services on a functional basis, the state's financial regulators—the Departments of Banking; Savings and Loan; Corporations; Insurance; and Real Estate—remain organized along *institutional* rather than *functional* lines.

This section analyzes the problems deregulation poses for the state and whether the Legislature has sufficient information to determine whether the state's regulatory system should be modified as a result of these changes in the marketplace.

Background

Banks (including commercial, investment, savings, mortgage and cooperative), savings and loan associations, credit unions, and loan companies were heavily regulated in the 50 years following the Great Depression. During that period, regulation represented a deliberate effort on the part of federal and state government to reinstill public confidence and reestablish stability in the financial marketplace.

The various federal and state regulatory agencies accomplished their objectives, in part, by restricting the types of investments which financial institutions could make and limiting the interest paid to depositors and the interest charged to borrowers. Restrictions on the types of investments the financial institutions could make effectively prohibited them from using depositors' funds for speculative or high-risk purposes. Competition among the various financial institutions was limited by setting the maximum interest rates they could pay on depositors' time and savings accounts and by restricting their geographic scope of operations. Thus, the financial institutions were principally deposit takers and loan makers and each had its specified role.

Specifically, banks served the financial marketplace primarily by making personal, commercial and agricultural loans and providing checking account services. Savings and loans were earmarked as the nation's home mortgage lenders. In contrast, credit unions were set apart as cooperative savings and lending institutions serving groups of individuals having a common bond such as workplace or cultural heritage. Although the individual roles of the financial institutions were different, each faced similar types of risk.

In addition to these regulatory mechanisms, the federal government established deposit insurance funds for member banks, savings and loan associations and credit unions. These funds are backed with the full faith and credit of the United States' Treasury. As an added step, both the federal and state regulatory agencies have developed separate regulatory systems for each type of financial institution and conduct periodic, sometimes joint, financial examinations.

For the most part, federal deposit insurance, interest rate controls and federal and state regulatory oversight, worked well to instill public confidence in the financial institutions and to establish stability in the financial marketplace.

Changes in the Marketplace Brings About Deregulation

During the latter part of the 1970s, the financial marketplace began to change. Because inflation was high, financial institutions found themselves facing greater interest rate risk than ever before. Moreover, depositors grew increasingly more sophisticated and assertive in seeking the best return on their investment dollar. It was during this time that competition for depositors' money increased between the financial institutions and those brokerage firms offering money market accounts. These accounts drained billions of dollars out of the banks, savings and loans, and credit unions, because they could offer the depositor liquidity and a higher rate of return than traditional saving deposits. This process served to weaken the competitive stance of financial institutions because of their inability to pay the higher yields to depositors.

Federal Deregulation. Congress acted in 1980 and again in 1982 to ease the plight of financial institutions. It did so by enacting legislation which, among other things, eliminated most of the purely legal and functional distinctions between financial depositories and authorized them to offer a deposit account that was directly competitive with money market accounts offered by brokerage firms. Federal actions served to deregulate the liability side (interest payments to depositors) of financial institutions' balance sheets.

California Deregulation. California also took steps to deregulate its state-chartered financial institutions. California's actions, however, were focused on deregulation of the asset side (broadening the types of loans and investments which could be made), as well as the liability side of the financial institutions' balance sheets. These actions at the federal and state level were successful in reversing the outflow of funds from the banks, savings and loans, and credit unions. But these changes also raised new risks for these institutions and their depositors.

Institutions were allowed for the first time to make *equity* investments in real estate, insurance, commercial ventures, and corporate securities. This change provided the opportunity to earn a higher rate of return, but it also increased the potential for losses.

Depositors were offered a wide variety of new investment opportunities, some of which were insured, and many of which were not. Due to the multitude of new investment opportunities offered by these institutions, it is now likely that many unsophisticated account holders pay more attention to the promised rates of return without fully realizing that some of the "accounts" are uninsured equity investments subject to the risk of losses.

The sharp increases in competition within the financial service marketplace has produced an upturn in failures, mergers, and consolidations. California has seen a growing number of financial institutions encounter serious financial problems such as American Savings, Heritage Bank and the Western Community Money Center. The Bank of America also has been troubled with high risk loans which have become unproductive. These problems have reduced public confidence in financial institutions generally and raised questions as to the effectiveness of current regulatory controls. They also have called into question the reliability of public information released by the state's regulators regarding the financial condition of financial institutions.

Summary. Federal and state deregulation has (1) removed many of the legal and functional distinctions between banks, savings and loans and credit unions; (2) introduced a new element of risk by permitting financial institutions to take an ownership position in commercial and real estate ventures; (3) introduced a new element of risk for the account holders by offering investment opportunities which are not insured, and (4) intensified competition between the different types of financial institutions and full service financial firms.

Deregulation and the State's Regulation of Financial Services

Our analysis indicates that, as a result of deregulation, the Legislature may need to:

- Reorganize the state's financial regulatory structure;

- Alter the resources available to the state's financial regulatory agencies; and
- Redefine the role of the state's financial regulatory agencies.

Regulatory Structure. Currently, the state's financial regulatory agencies are independent of one another and, consequently, no effective mechanism exists to coordinate and harmonize their regulatory activities in a deregulated environment. Each agency maintains separate administrative, examination, legal, and enforcement staffs, and computer files on its licensees. Moreover, each agency has differing rules, regulations, field examination practices, and accounting and reporting procedures.

Fragmentation in the state's financial regulatory structure has existed for many years. As such, it was not uncommon, for example, to find a real estate development firm regulated by both the Department of Real Estate (because of its subdivision projects) and the Department of Corporations (because it had sold stock to the public). This situation did not post serious problems for the regulatory system because the activities were essentially separate.

In a deregulated environment, where the lines between previously separate industries have disappeared, a fragmented approach to regulation can lead to serious problems. Specifically, as a result of deregulation, the same real estate development firm also can form a savings and loan association to finance its projects. This makes it subject to regulation by a third state agency—the Department of Savings and Loan. Under such circumstances, serious regulatory problems could occur because the activities of the development firm and the savings and loan are so closely linked. If, for example, the development firm incurred a major loss on a subdivision financed by its savings and loan, the financial viability of the savings and loan could be impaired as well. Thus, deregulation appears to have increased the need for better coordination among the state's financial regulatory agencies.

Resource Needs. The current and future resource needs of the state's financial regulatory agencies are dependent on policy changes at the state and federal level brought about by deregulation. Specifically, deregulation has prompted a recent agreement between federal and state regulators that effectively results in a need for more state field examination staff. A further shift of federal regulatory responsibility to the state will occur if Congress approves the recommendations of a task force which was appointed by the President to study ways to simplify the federal regulatory structure and eliminate overlapping and duplicative regulatory effort. One major recommendation of the federal task force would shift—from federal regulators to state regulators—the responsibility for conducting field examinations of state-chartered financial institutions. This proposal, if implemented, could require the Legislature to increase significantly the examination staffs of the Departments of Banking and Savings and Loan. Thus, deregulation may alter the resource needs of the state's financial regulatory agencies.

Regulatory Role. In the past, the primary role of the state's financial regulatory system has been to protect the public from economic loss. To accomplish this objective, state regulators relied on periodic examinations to determine whether the operations of financial service providers were both safe and sound.

In a deregulated financial services marketplace, the role of the regulators may need to be redefined to include: (1) more in-depth evaluations of the soundness of these institutions' financial activities, and (2) expanded consumer protection.

Prior to deregulation, the typical types of assets held by financial institutions and evaluated by regulators included *secured* business, agricultural, consumer, and real estate loans plus U.S. government and municipal securities. Now regulators must evaluate *unsecured* equity investments made by these institutions. The complexity of these new types of investments raises the question of whether the regulators have the expertise, training and staff necessary to perform their new role. Also there is the question of how much information the regulators should publish on the financial condition of these institutions so that potential investors are adequately informed of the risks associated with each institution.

Consumers very often incorrectly assume that because they are dealing with traditional institutions, their investments are subject to traditional protections (that is, insurance). For many customers, the "jargon" used by these institutions does not clearly delineate between insured deposits and uninsured equity investments. Moreover, the various types of insurance now in effect are not standardized. For example, deposit insurance offered by the Federal Deposit Insurance Corporation (FDIC) and the state's Thrift Guarantee Corporation (TGC) differ significantly as to (1) the amount of deposit protection provided, (2) specific payout provisions if an institution should fail, and (3) the reliability of their ultimate financial backing (in the case of the FDIC and TGC, ultimate financial backing is provided by the U.S. Treasury and the thrift industry, respectively).

Thus, as a result of deregulation, the role of the state's financial regulatory agencies may need to be redefined.

The State's Financial Regulatory System In a Deregulated Environment

We recommend that legislation be enacted creating a blue-ribbon task force, consisting of industry, academic, administrative and legislative representatives, to reexamine the state's regulatory role pertaining to financial institutions. We further recommend that the task force submit periodic progress reports to the Legislature and the Governor, and that the final report, with its recommendations, be submitted in 1986.

Given the volatile changes that have occurred as a result of deregulation, it is becoming increasingly clear that the state's financial services regulatory system, which was designed for a marketplace that no longer exists, needs to be critically reexamined.

Budget Proposal. The Governor's Budget for 1985–86 recognizes that changes are needed in this area. The budget proposes $300,000 (Item 0520) to finance a private consultant's study of the state's existing financial regulatory structure and the changes in the financial services marketplace. We have evaluated the Governor's proposal (please see page 32 of the *Analysis*) and found that (1) the scope of the study is not clearly defined; (2) the cost estimate is not substantiated; and (3) no provision is specifically made to provide the Legislature with the results of the study.

Task Force Alternative. Our analysis indicates that additional information *is needed* regarding the effects of financial deregulation on the state's regulatory system. Specifically, the Legislature needs better information (1) to evaluate the impact of deregulation on the state's financial marketplace, (2) to analyze the state's current financial regulatory structure in light of recent developments, and (3) to develop alternatives which would streamline the regulatory structure and increase its efficiency and cost-effectiveness.

Due to the complexity of this issue and its impact on the private as well as public sectors, representative participation by the affected parties is essential. Therefore, in lieu of a private consulting contract, we recommend that the Legislature secure the needed information by enacting legislation creating a blue-ribbon task force, consisting of representatives of the financial industry, academic institutions, the administration, and the Legislature. The task force should be directed to submit periodic progress reports to the Legislature and the Governor and a final report during 1986.

Specifically, we recommend that the legislation direct the task force to:

- Conduct a comprehensive evaluation of the current and likely future effects of federal and state deregulation on California's financial service marketplace.
- Evaluate the state's current financial regulatory structure and determine what changes are needed in regulatory policies, programs and organizations vis-a-vis federal regulatory agencies. This review also should consider (1) the impact of potential changes in the roles of federal financial regulatory agencies on their state counterparts and (2) whether the state's existing decentralized regulatory structure should be replaced by a consolidated state regulatory organization.
- Determine what changes need to be made in the state's policies and procedures for examining and reporting on the financial condition of financial institutions.

- Ascertain what changes are needed to enhance consumer awareness of the risks involved in new types of investments, and what protections should be extended to traditional types of deposits.
- Provide the Legislature and the Governor with specific recommendations for legislation to implement such changes.

COMPARABLE WORTH

Is "Comparable Worth" an Effective and Efficient Means of Achieving State Employment Goals?

One of the most controversial issues in the area of public sector labor relations and compensation is the issue of "comparable worth." This concept envisions the payment of equal wages to different job classifications having comparable value.

Background

In California, the issue of comparable worth came to the forefront during legislative action on the 1984 Budget Bill. The Legislature augmented the 1984–85 employee compensation packages for state employees by $76.6 million ($46.3 million General Fund) in order to provide comparable worth pay adjustments to some of these employees. At the same time, the Legislature approved a bill (SB 1701) establishing a Commission on Pay Equity, which would have conducted a comparable worth pay study. The Governor vetoed both the pay increases in the Budget Bill and SB 1701.

The comparable worth issue was back in the headlines in November 1984, when the California State Employees' Association filed a sex-based wage discrimination lawsuit against the state on behalf of state employees in female-dominated job classifications. The lawsuit seeks, as relief for these employees, back pay to redress sex-based discrimination in wages.

The Concept of Comparable Worth. Comparable worth is a concept based on two related premises:

1. Jobs which are dissimilar in terms of both content and the demands they place on the worker may nonetheless be compared objectively in order to determine their *relative* value or worth.

2. Jobs which are approximately of the "same worth" should be compensated equally.

Conceptually, comparable worth can be used to address relative disparities between any job classifications. In practice, however, the concept has been used most often to highlight pay differentials between men and women.

Proponents of comparable worth argue that, because of both deeply ingrained sex-related cultural biases and outright sexual discrimination against women in employment practices, women have been restricted to lower-paying jobs. Because these discriminatory effects are so pervasive, they assert that an alternative to the "free market" determination of wages (such as comparable worth) is needed in order to counteract these effects.

Federal Anti-Discrimination Law. There are two main federal laws covering employment discrimination. The Equal Pay Act of 1963 established the doctrine of equal pay for work of equal value, and Title VII of the 1964 Civil Rights Act prohibits discrimination because of race, color, religion, sex, or national origin in all employment practices. The federal courts are in the process of interpreting the extent to which these anti-discrimination statutes are relevant to lawsuits involving comparable worth.

In one important case—*American Federation of State, County and Municipal Employees v. Washington State* (December 1983)—a federal district court judge found the State of Washington guilty of Title VII violations for failing to implement the results of a comparable worth study. This case is currently on appeal.

The U.S. Supreme Court, to date, has shied away from the issue of comparable worth. For example, the court recently refused to review an appellate court's decision in *Spaulding v. University of Washington,* which ruled that the university's nursing faculty could not bring a discrimination suit under Title VII solely because its members were paid less than faculty members with comparable duties at other schools within the university system.

State Employment Practices

In the past, the state generally has set salaries and wages on the basis of comparability with private sector compensation levels. Thus, the state has followed a "market" approach to setting pay levels.

The relatively recent passage of two measures, however, has significantly affected the state's traditional approach to compensating its employees. First, Ch 1159/77 (the State Employer-Employee Relations Act) made the determination of wages and salaries subject to collective bargaining.

Second, Ch 722/81, stated *legislative intent* that it is the state's policy to set salaries for female-dominated jobs on the basis of comparable worth. (Ch 641/83 established the same policy for California State University employees.) Prior to legislative action on the 1984 Budget Bill, however, there was little action by the state or employee unions to implement this policy.

Efforts to Alleviate Underrepresentation. Independent of the way in which state employee wages are set, the state has taken steps during the last decade to address the underrepresentation of females, minorities and disabled persons in the state workforce. The State Personnel Board (SPB), the agency which oversees the state's affirmative action program, has acted to:

- Provide extensive departmental affirmative action reviews;
- Expand recruitment activities targeted at underrepresented groups;
- Create and expand upward-mobility programs;
- Expand eligibility for certain exams in order to broaden participation;
- Use temporary appointments and training and development assignments to provide new job opportunities; and
- Create new apprenticeship programs.

Currently, SPB is involved in a special project designed to address the problems of recruiting, hiring, and retraining women in crafts and trades classifications. The board has provided specific recommendations to 13 departments to assist them in this regard. Furthermore, SPB is considering general recommendations on how to remove employment barriers in these trade occupations.

The Feasibility of the Comparable Worth Concept

Our review identifies three issues that should be addressed by the Legislature as it considers the comparable worth concept. These issues are as follows:

- Are the premises underlying the comparable worth concept valid?
- Would comparable worth help achieve the Legislature's main employment objectives?
- What are the implications of making the kind of drastic change in the way the state pays its employees that comparable worth envisions?

Are the Premises Underlying Comparable Worth Valid? Implicit in many of the arguments advanced on behalf of comparable worth are two premises: (1) the huge "wage gap" between men and women requires a radical departure from current compensation practices and (2) traditional efforts to correct "market imperfections" (such as affirmative action programs aimed at improving *access* to certain job classifications) are not sufficient to do the job.

The "wage gap" premise is based on the oft-quoted statistic that the average earnings of an American female is only three-fifths that of a male's. Many have wrongly assumed, however, that discrimination accounts for the entire difference. In fact, when differences in nondiscriminatory factors (such as length of workweek, education, and experience) are taken into account, the "unexplained" portion of the wage gap is typically in the 10 to 25 percent range. Economists assume that a good portion of this unexplained portion is, in fact, due to discrimination.

The need for comparable worth also seems to be based on the premise that the state has not acted effectively enough to address underrepresentation of females in the state work force. Currently, women comprise 44 percent of the state's work force, but tend to be concentrated in certain occupational classifications—particularly clerical-related jobs.

Table 53 shows the proportion of state jobs held by women in each of the twenty major categories covering all state employment. The table indicates that, with few exceptions, between 1975 and 1984 there were large percentage increases in the representation of women within each category. These gains have been realized, in large part, as a result of specific actions by the state to improve women's access to jobs. They also reflect the changing cultural mores which have dramatically affected women's work force participation.

Table 53 also clearly illustrates that, despite significant progress in the last 10 years, women still are underrepresented in most categories, especially in crafts and trades, law enforcement and management positions. It is not clear to us, however, that comparable worth in any way addresses this problem, as discussed below.

Table 53
Percent of Women in the State Work Force
By Major Job Categories
1975, 1981, and 1984

Job Categories	*Percent of Total Employees 1984*	*Percent Women In Each Category 1975*	*1981*	*1984*	*Percent Increase, 1984 Over 1975*
Office Support:					
Clerical	16.8%	88.6%	89.6%	89.2%	0.7%
Supervisory clerical	3.5	86.0	83.6	83.3	−3.1
Crafts and Trades:					
Semiskilled	2.8	0.3	5.8	7.3	—[a]
Crafts/trades	3.0	4.8	3.1	2.8	−41.7
Supervisory crafts/trades	3.7	0.3	0.6	1.5	400.0
Laborers	0.6	0.2	3.5	9.8	—[a]
Custodial:					
Janitor/custodian	2.7	32.6	39.4	38.4	17.8
Supervisory janitor/custodian	1.0	30.1	34.3	35.6	18.3
Professional and Technical:					
Professional	16.6	30.8	32.6	38.2	24.0
Supervisory professional	7.5	14.8	16.2	16.8	13.5
Sub-professional/technical	13.6	43.8	59.4	60.8	38.8
Supervisory sub-professional/technical	2.7	24.0	38.2	40.4	68.3
Field representative	2.3	12.0	31.0	40.6	238.3
Supervisory field representative	1.6	6.0	13.5	19.1	218.3
Law Enforcement:					
Line	8.7	3.0	8.9	12.3	310.0
Supervisory	1.8	2.1	3.1	5.7	171.4
Administrative:					
Administrative staff	5.3	30.5	54.8	54.9	80.0
Supervisory administrative staff	3.5	15.3	31.3	32.4	111.8
Administrative line	1.1	3.0	9.4	11.6	286.7
COD Classes	1.1	59.8	62.0	59.6	−0.3
Total employees	100.0%[b]	38.6%	44.1%	44.0%	14.0%

[a] Exceeds 2000 percent
[b] Details may not add to totals due to rounding.

Is Comparable Worth Aimed at the Right Objective? It is impossible to assess the concept of comparable worth as a means of achieving state employment goals without knowing the Legislature's objectives. Actions taken by the Legislature to date *suggest* (we can't be certain) that the Legislature's main objective is to improve women's *access* to all job classifications. That is, there should be no unnecessary barriers to the movement of individuals into whatever positions they are qualified to hold.

If this is the case, it does not appear that comparable worth is an appropriate or effective means to achieve this desired end. Comparable worth is aimed at changing the *relative* wage levels *among* job classifications, not in changing the male-female composition of existing classifications. This is because comparable worth does not in any way address barriers or restrictions which preclude women from entering certain classifications; rather, it addresses only what employees in existing classifications "should" be paid.

It may be, however, that the Legislature would want to implement comparable worth for *other* reasons. For instance, it could be used as a method for compensating female employees for past discrimination.

Thus, in considering whether to implement a comparable worth program, it is crucial that the Legislature specify what its objective is.

Comparable Worth Is a Drastic Change in Employee Compensation. Although comparable worth has been advanced as a means of addressing pay discrepancies between women and men, the concept has much broader applicability. If fully implemented, it would completely change the way wages for *all* classifications are determined.

Compensation levels currently are set through collective bargaining—presumably within the constraints imposed by the labor market. Under comparable worth, however, wages presumably would be established based on a consulting firm's judgment as to what the appropriate standards are for determining job worth within an organization (usually referred to as "point-factor" evaluations). There is no consensus, however, on what specific criteria should be used in setting these standards for determining job worth. Nor is it clear to us why the Legislature should be confident that the standards used by one group are "fairer" or "better" than those of another consulting firm.

Potential Negative Consequences of Implementing Comparable Worth

In addition to questioning the validity of the premises underlying comparable worth, we believe that implementation of a comparable worth program at the state level could have certain *adverse* consequences that the Legislature should keep in mind. Specifically,

- ***Comparable worth could discourage, rather than improve, the access of women to nontraditional jobs.*** If comparable worth were to achieve the intended effect of raising wages in female-dominated jobs, it would work at cross purposes to the goal of ensuring women's *access* to male-dominated jobs. This is because women would have less of an incentive to seek higher-paying and/or nontraditional jobs.
- ***Implementation of comparable worth can be very costly.*** Conceptually, comparable worth could be implemented at *no* cost to the state. Since the concept deals only with *relative* wage rates, any increased costs from raising wages in female-dominated classifications *could be* offset by *reducing* wages in other classifications. Practically, however, wages tend to *level up,* resulting in additional compensation costs to the implementing entity.
- ***Comparable worth could reduce employment opportunities for female workers now employed by the state.*** This is because a sharp rise in salaries for female-dominated occupational categories would tend to accelerate the search for less labor-intensive ways of providing these services. For example, a sharp increase in salaries for clerical workers would tend to make state office automation projects all the more attractive.
- ***Implementation of comparable worth could lead to shortages in certain occupational classifications.*** To the extent that a comparable worth assessment of a job's "value" is *less than* the market's, it will be difficult to fill these jobs at the "designated" salary. Thus, it is unclear how the state would be able to recruit and retain needed workers in all classifications if a comparable worth program were implemented.

Conclusion

In order to remove the remaining barriers confronting women who would like to move into male-dominated classifications, we recommend that the Legislature establish a special unit within the State Personnel Board devoted solely to improving access for women into nontraditional classifications.

There is no doubt that cultural biases and various forms of discrimination have affected the employment status of women in state government. Moreover, job barriers—both overt and subtle—remain which will preclude full and widespread participation of women in all categories of the state work force for many years to come.

Our review indicates, however, that the state has adopted the best policy direction for rectifying this problem by attempting to remove these barriers and to both encourage and assist women in pursuing nontraditional jobs. During the last decade, in fact, the state has achieved significant success in improving representation by women in virtually all job classifications.

Clearly, further success in this effort is needed if the state is to achieve its employment objectives. It is not at all clear to us, however, how a comparable worth program would contribute toward those ends. Our analysis indicates that implementation of the comparable worth concept: (1) would not help women in entering nontraditional occupations, (2) would probably be very costly (although *conceptually* there is no reason why its implementation has to result in *any* costs), and (3) could result in reduced employment of female workers and employee shortages in certain state classifications.

In short, it appears to us that comparable worth is neither an efficient nor effective means of achieving state employment objectives. Consequently, we recommend that the Legislature continue to rely on: (1) private sector comparability data in evaluating the compensation of state workers (within, of course, the context of collective bargaining), and (2) affirmative action efforts to improve access into nontraditional jobs.

With regard to the latter, however, we believe the state could do more than it is now doing to find and remove those remaining barriers confronting women who would like to move into male-dominated classifications. Currently, SPB does not have staff to thoroughly review departmental personnel practices in order to:

- Identify barriers preventing women from entering certain classifications,
- Promote upward mobility of women into male-dominated classes; and
- Assist departments in recruiting women in such classes.

Accordingly, we recommend that the Legislature establish a special unit within the SPB, devoted solely to improving access for women into nontraditional job classifications. While we have not received specific information from the board as to the number of staff needed to perform such a function, it appears to us that a five- to six-person unit (at an annual cost of approximately $250,000) could adequately perform this task.

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