Placement Options for Youthful Offenders

How Can the State and Counties Provide Services to Youthful Offenders in a More Cost-Effective and Beneficial Way?

Summary

- In the current year, the average daily population of youths who have been removed from home under the authority of the juvenile court and placed in county facilities, foster care, or the Department of the Youth Authority will be about 23,600.
- Although juvenile arrest rates and the juvenile population have been declining over the past five years, the number of juveniles placed in these facilities has grown dramatically. This increase is due to both increasing admissions and longer stays. As a result, California has the highest juvenile custody rate of any state in the nation for county and state facilities combined.
- Probation departments and the juvenile courts have rather limited options for the treatment of wards. The majority of wards either stay at home with limited supervision by probation departments, or they are removed from home and placed in 24-hour care facilities.
- The current funding arrangements provide fiscal incentives for counties to place wards in particular facilities based on the state and county share of costs, rather than on the treatment needs of the ward and the total cost of the placement.
- The Legislature can address these problems through development of treatment alternatives (such as placement prevention services, special foster family homes, and day treatment programs), and changes in the existing funding arrangements for treatment services.

According to the U.S. Department of Justice, California has the highest juvenile custody rate in the nation. As a result, the state and counties pay almost $600 million a year to place youthful offenders in various 24-hour facilities (camps, juvenile halls, institutions, and foster care arrangements). It may be, however, that alternative placement options could be made available, which could improve services to these offenders and provide incentives for more cost-effective care.

In this analysis we first discuss the characteristics of youthful offenders and the treatment options available to them in the juvenile justice system at the local and state levels. We then examine the pressures that lead counties to rely on state support for the juvenile justice system. Finally, we outline several options the Legislature may wish to consider to help counties address the needs of juveniles and to reduce the costs to the state.
THE JUVENILE JUSTICE SYSTEM

Minors who become wards of the court include both “status offenders” (such as truants, runaways, or “incorrigibles”), who engage in activities that are prohibited for juveniles only, as well as youths who have violated laws that also apply to adults. Generally, youths who fall into either of these categories are between the ages of 8 and 18. Once a youth has been detained and made a ward of the juvenile court, a determination is made by the court, upon the recommendation of the probation department, as to the treatment needs of the person. The ultimate goal is to provide the ward with the treatment necessary to enable the ward to function in society and avoid a return to the juvenile or criminal justice systems. Generally, the treatment of choice is to maintain the ward at home. If however, the court determines that a specific type of placement outside of the ward’s home is necessary, the probation department is required to place the ward in the least restrictive and most family-like setting available.

For wards in out-of-home placement, the probation departments are charged with the additional responsibility of reunifying the ward with his or her family or preparing the ward for independent living. The decision to attempt family reunification depends on the age and abilities of the ward, as well as the stability of the family.

Placement Options

When dealing with youthful offenders, probation departments have a choice of offering a youth “informal probation,” which does not involve a court decision or bringing a youth before the juvenile court for a determination regarding treatment. Chart 1 shows that about one-quarter of all juveniles appearing in court are either placed on informal probation or are dismissed by the court.

In general, counties have four basic choices for the treatment of those youths whom the juvenile court declares as wards.

Placement Back at Home. In about one-third of juvenile cases, a ward is placed on probation at home. While on probation, he or she may be periodically contacted by probation officers and may receive court-ordered services (such as counseling) or be required to perform community service. This option is generally for the youngest, least serious offenders with little or no history of delinquent behavior. Frequently, these wards will have spent some short amount of time waiting in juvenile hall for a hearing and disposition of their case. In the remaining cases, the ward is removed from home and one of the following “out-of-home” placements is made.
**Chart 1**

**Dispositions of Juvenile Offenders**

*November 1987*

- Informal probation/dismissal (26%)
- AFDC-FC (12%)
- CYA (3%)
- County juvenile halls, ranches and camps (25%)
- Home on probation (34%)

---

**Commitment to a Juvenile Hall, Ranch, or Camp.** In about a fourth of all cases, wards are committed to a county facility. All counties are required by law to operate juvenile halls or contract for bed space in the hall of a neighboring county. Juvenile halls are locked facilities that are normally used for short-term detention of about two to three days prior to a hearing, and for commitments of around 30 to 60 days. Because juvenile halls are intended to be short-term placements, the treatment services that are available usually are oriented to crisis intervention. Services usually include some type of mental health counseling, drug and alcohol programs, and suicide prevention. A ward is expected to attend school at the hall. According to a recent Youth Authority study, the average length-of-stay in a juvenile hall is 19 days.

County ranches and camps are used for longer-term placements—about five months on average—for the most serious offenders that a county serves at the local level. Ranches and camps frequently are not locked facilities but are located at some distance from the community. Currently, 19 counties operate ranches or camps. These facilities provide education and some vocational services, as well as treatment programs including drug and alcohol counseling and family counseling.
Foster Care Placements. In about 12 percent of the juvenile court decisions, wards are placed in foster care under the Aid to Families with Dependent Children-Foster Care program (AFDC-FC). These are usually group homes, which can range in size from six beds to over 100 beds, but some placements are also made in family homes (less than six beds). The group home placements mostly are used for the sociological, psychological, or psychiatric treatment of the ward. The group homes are not locked facilities and are usually located within a neighborhood setting, rather than in a more remote location as are ranches and camps. As with the other placement options, education is required for all wards age 18 or under. Treatment programs in various group homes usually last from 12 to 18 months. They tend to provide a spectrum of services, from individual and group counseling to psychiatric attention and medication. The variety of services offered to a ward is often greater than in placements in a county facility.

Commitments to the Youth Authority. In only about 3 percent of juvenile court dispositions are wards committed to the California Youth Authority (CYA). Many local officials consider the CYA to be the placement of last resort for juvenile court wards. Two-thirds of the juveniles who are committed to the CYA for the first time have previously been in placement somewhere else in the juvenile justice system. The CYA is the most secure setting available for a ward and also has the longest length-of-stay—an average of 20.5 months. The wards in the CYA receive educational and vocational training based on their age and abilities. Specialized counseling programs are available to a limited number of wards committed for certain types of offenses or having particular problems. Wards in placement in the CYA have service needs that range from remedial education to psychiatric treatment. CYA wards are older on average than wards in other placements, and generally have had a more extensive and/or more serious record of delinquent behavior than other wards.

Characteristics of Wards in Out-of-Home Placement

Table 1 shows selected characteristics of wards in out-of-home placements within the state’s juvenile justice system. The data show that most of the wards who have been removed from home are in their mid to late teenage years, have had previous contact with the juvenile justice system, and have been in placement before. The table also shows that juveniles are involved most frequently in property crimes, and that drug- and alcohol-related offenses are also prevalent. Juveniles who committed violent crimes are represented in larger proportions as the security of the placement increases.
Table 1  
Characteristics of Juvenile Court Wards  
by Type of Out-of-Home Placement  
1987  

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>County Facilities</th>
<th>CYA First Commitments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>AFDC-FC</td>
<td>Juvenile Halls</td>
</tr>
<tr>
<td>Average age (years)</td>
<td>15.0</td>
<td>16.1</td>
</tr>
<tr>
<td>Ethnicity:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>White</td>
<td>55%</td>
<td>34%</td>
</tr>
<tr>
<td>Black</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td>Hispanic</td>
<td>16</td>
<td>32</td>
</tr>
<tr>
<td>Asian</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
<td>-a</td>
</tr>
<tr>
<td>Sex:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>63%</td>
<td>-a</td>
</tr>
<tr>
<td>Female</td>
<td>37</td>
<td>-a</td>
</tr>
<tr>
<td>Education (average grade level)</td>
<td>-a</td>
<td>-a</td>
</tr>
<tr>
<td>Primary commitment offense:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Violent</td>
<td>8%</td>
<td>-b</td>
</tr>
<tr>
<td>Property</td>
<td>33</td>
<td>-b</td>
</tr>
<tr>
<td>Drug/alcohol</td>
<td>39</td>
<td>-b</td>
</tr>
<tr>
<td>Other (includes probation violation)</td>
<td>-a</td>
<td>-b</td>
</tr>
<tr>
<td>Length-of-stay (months)</td>
<td>15.1</td>
<td>0.6</td>
</tr>
<tr>
<td>One or more prior offenses</td>
<td>-a</td>
<td>77%</td>
</tr>
<tr>
<td>One or more prior out-of-home placements</td>
<td>68%</td>
<td>-a</td>
</tr>
</tbody>
</table>

*Data not available.

b Included in “Ranches and Camps” population.

According to information provided by several county probation departments to the Health and Welfare Agency’s Out-of-Home Care Task Force, wards of the court tend to have many common characteristics. These include substance abuse problems, emotional/psychological problems, undeveloped social skills, learning disorders, average to low IQ, poor school attendance, a history of running away, parents with emotional or drug and alcohol problems, and parents who are neglectful and unable to provide adequate care and control for the minor.

Also, it is not uncommon for a ward at one time to have been a “dependent” of the court due to parental abuse, neglect, or exploitation. In fact, information gathered by the Out-of-Home Care Task Force and our own interviews indicates that wards tend to be similar to dependents of the court with regard to their psychological health, educational achievements, and family situations. These similarities are important to be aware of in determining the needs and providing for the treatment of wards.

The Number of Wards Placed in Facilities

Chart 2 illustrates the average daily population between 1984 and 1988 for each of the out-of-home placement options, with the county commit-
ments broken out between juvenile halls and camps/ranches. The chart shows that juvenile hall populations have increased slightly during that time, while the camp population has been relatively stable. The AFDC-FC population, however, has increased by about 38 percent. The CYA population also has increased steadily over the period, growing by about 58 percent.

The figures mentioned above regarding placement decisions and the information in Chart 2 demonstrate how important length-of-stay is in determining the average daily population of a program. Although commitments to the CYA occur very infrequently compared to other placements (3 percent), the population of the CYA is much higher. This is due to the length of time a ward stays in CYA facilities (an average of 20.5 months). The average length-of-stay in a CYA institution has increased by 5.7 months, or 39 percent, since 1982-83. The same point can be made about AFDC-FC placements. Since 1983, the average length-of-stay in foster care has grown by about 18 percent.

The increasing length-of-stay is a result of policy decisions regarding how to address juvenile delinquency, rather than a result of an increase in the number or seriousness of juvenile crimes. For example, the juvenile arrest rate has declined by nearly 12 percent since 1980, according to information prepared by the CYA. More specifically, the
rate of felony arrests of juveniles has declined by about 18 percent, while
the rate for misdemeanors has declined 8.4 percent. The number of
arrests also has declined over the same period, as arrests for violent
crimes have decreased 27 percent, and arrests for property crimes have
decreased by 29 percent. These decreases in arrest rates and the number
of arrests are in direct contrast to the growing population and the
increasing length-of-stay in juvenile facilities. According to a recent CYA
study, there is no correlation between juvenile arrest rates and juvenile
incarceration rates. Instead, the rate of incarceration in a particular
county is dependent on the policies of that county regarding the use of
custody as a treatment for youthful offenders.

The Cost of Providing Out-of-Home Placements

Table 2 shows our estimate of the average daily and annual cost of
treating wards under the out-of-home placement options. We estimate
that in the current year the state, counties, and federal government will
spend over $600 million in California to maintain the youthful offenders
who are placed outside of their homes in state, county, or private
facilities. The table shows that counties provide most of the funding for
juvenile halls and camps, while the state provides most of the funding for
the AFDC-FC program and the CYA. The General Fund will provide
about $373 million, primarily for wards in AFDC-FC placement and in
the CYA. The counties will provide about $210 million for wards placed
in county facilities as well as for the county shares of the AFDC-FC and
CYA placements. The federal government provides funding only for the

<table>
<thead>
<tr>
<th>Table 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Placement Costs in the Juvenile Justice System</td>
</tr>
<tr>
<td>1988-89</td>
</tr>
<tr>
<td>(dollars in millions)a,b</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Average Daily Population</td>
</tr>
<tr>
<td>Average Daily Cost</td>
</tr>
<tr>
<td>Annual Funding:</td>
</tr>
<tr>
<td>General Fund</td>
</tr>
<tr>
<td>County Funds</td>
</tr>
<tr>
<td>Federal Funds</td>
</tr>
<tr>
<td>Totals</td>
</tr>
</tbody>
</table>

a Costs in table do not include overhead costs associated with county or state departments.
b"Average Daily Cost” in actual dollars, not in millions.
c Includes 1,110 juveniles convicted in criminal court, and sentenced to the the Department of Corrections but housed in the Youth Authority.
d County Justice System Subvention.
Sources: LAO estimates based on information provided by the Youth Authority, the Department of Social Services, and county probation departments.
AFDC-FC program (about $19 million). All of these cost figures underestimate the full costs of these programs because they do not include administrative or overhead costs that are associated with the state or county departments that administer these programs. A comparison of the full costs of the programs was not possible due to the unavailability of data for several of the placement options.

Table 2 also shows the wide variance in the cost per day per ward for these out-of-home placements. The AFDC-FC program has both the lowest daily cost option—$15 per day in a foster family home—and the highest daily cost option—almost $84 per day in a group home. The relatively low per ward cost in the CYA is due to the fact that its population is at 150 percent of the institutions' capacities. Based on cost data provided by the department, the average cost per ward would be about $82 per day if the department were operating at about 100 percent capacity.

**SYSTEM DEFICIENCIES**

Our review of the placement process for juvenile offenders indicates that the juvenile justice system suffers from two basic problems. First, probation departments and the juvenile court have rather limited options regarding the treatment of wards of the court. Second, the manner in which the state and counties fund these options provides fiscal incentives for the counties to place wards in particular facilities.

**Treatment Options Are Limited**

Our review of the current system of services provided to youthful offenders indicates that it is polarized between providing little or no service to wards at home and providing intensive services in a residential setting—that is, the 24-hour care provided by all of the out-of-home placement options. Generally, there is not a continuum of services available to match the variations among wards. According to many juvenile justice professionals, a continuum of services would better serve the goal of preventing the removal of wards from their homes. For example, during our interviews several juvenile court judges expressed the belief that they often must remove a ward from home for placement in a residential program because there are no nonresidential treatment options available, rather than because that is the most appropriate treatment for the ward. This situation may account for the unusually high proportion of wards removed from home. Specifically, according to the U.S. Department of Justice, California's admissions to juvenile facilities account for 25 percent of admissions nationwide, although the state has only about 10 percent of the nation's juvenile population.
Table 3 shows a continuum of services—from preplacement services to intensive parole supervision—that probation departments indicate would be desirable to provide to wards. These services, however, are not generally available in most counties. If they were, it is likely that some of the wards who are removed from home and placed in residential care instead could be maintained less expensively at home.

Table 3

<table>
<thead>
<tr>
<th>Service</th>
<th>Purpose</th>
<th>Wards Eligible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Placement prevention</td>
<td>Provide supervision and diversion programs in order to avoid removal from home.</td>
<td>Less serious offenders with stable families.</td>
</tr>
<tr>
<td>Day Treatment</td>
<td>Provide education and training during the day to wards who otherwise would have to be placed out-of-home.</td>
<td>Nonviolent wards with stable families who need a structured program but not residential care.</td>
</tr>
<tr>
<td>Mental Health Residential Facilities</td>
<td>Diagnosis, stabilization, and psychological/psychiatric treatment.</td>
<td>Mentally disturbed or emotionally disabled wards who cannot be maintained at home.</td>
</tr>
<tr>
<td>Secure Treatment Facilities</td>
<td>Secure setting for treatment instead of custody.</td>
<td>Runaways and violent or self-destructive wards who need close supervision.</td>
</tr>
<tr>
<td>Emancipation Programs</td>
<td>Provide job training and life skills to prepare wards to live independently.</td>
<td>Wards on or nearing parole who will not be reunified with their families.</td>
</tr>
<tr>
<td>Intensive Parole Supervision</td>
<td>Provide extra supervision in order to encourage good behavior and avoid re-incarceration.</td>
<td>Wards on parole who are at-risk of parole revocation.</td>
</tr>
</tbody>
</table>

Thus, the provision of a broader range of services to wards has the potential of improving the treatment services provided to wards (by better targeting treatments to individual needs) and saving money (by substituting less expensive nonresidential care for out-of-home placements). Currently, however, there are no incentives to develop a diversity of programs and services. Within the existing structure of state-supported residential programs, there is little flexibility for counties to develop specific programs for wards who have specialized treatment needs. Moreover, most counties have relatively limited discretionary income available to pay for these or other services.

The lack of treatment options also results in other negative consequences for the juvenile justice system:

**High Level of Out-of-County Placements.** According to various probation officials we interviewed, a shortage of service and treatment options within a county often leads to out-of-county placements, especially in the foster care system. If a county does not have a program for particular types of wards within its boundaries, probation departments will make efforts to place the ward wherever an appropriate program exists. This could mean placement in the next county, across the state,
even out of state. Table 4 shows the number of wards placed in foster care both in and out of their county of residence in a sample of 10 counties. It indicates, for instance, that in March 1988 Sacramento County placed 80 of its wards within the county and 74 outside of its boundaries, while accepting 190 placements from other counties.

Table 4
Location of Ward Placements in Foster Care for 10 Selected Counties March 1988

<table>
<thead>
<tr>
<th>County</th>
<th>Placements of County Residents</th>
<th>Placements of Other Counties’ Residents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>In County of Residence</td>
<td>Out-of-County</td>
</tr>
<tr>
<td></td>
<td>39</td>
<td>323</td>
</tr>
<tr>
<td></td>
<td>37</td>
<td>140</td>
</tr>
<tr>
<td>Imperial</td>
<td>1</td>
<td>25</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>834</td>
<td>245</td>
</tr>
<tr>
<td>Riverside</td>
<td>74</td>
<td>132</td>
</tr>
<tr>
<td>Sacramento</td>
<td>80</td>
<td>74</td>
</tr>
<tr>
<td>San Bernardino</td>
<td>138</td>
<td>236</td>
</tr>
<tr>
<td>San Mateo</td>
<td>12</td>
<td>65</td>
</tr>
<tr>
<td>Stanislaus</td>
<td>29</td>
<td>71</td>
</tr>
<tr>
<td>Ventura</td>
<td>29</td>
<td>14</td>
</tr>
<tr>
<td>Statewide</td>
<td>2,139</td>
<td>2,922 a</td>
</tr>
</tbody>
</table>

*Statewide totals for wards placed out-of-county do not equal those placed from other counties because the location of some wards was not available. Also, “Out-of-County” includes 167 wards placed out-of-state.

Although out-of-county placements sometimes may offer the most appropriate program for a ward, they also present several problems for the placing counties and for the wards. First, the cost to place a ward outside his or her county of residence is higher to the placing county, due to additional transportation costs and staff time involved with visits to the ward. In addition, efforts to reunify the family are hindered by out-of-county placements, as visits with family and family treatment are more difficult when the ward is placed far from home. Also, paroling a ward back into the community is made more difficult as the ward has been removed from the community’s educational and employment resources.

Overcrowding Juvenile Halls. A lack of placement options has also contributed to overcrowding of county juvenile halls. Table 5 illustrates the magnitude of the overcrowding problem experienced by those seven counties with the highest incidence of overcrowding.
Table 5
Overcrowding in Juvenile Halls
January 1987 through December 1987

<table>
<thead>
<tr>
<th>County</th>
<th>Total Days of Overcrowding</th>
<th>Number of Juveniles</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imperial</td>
<td>185</td>
<td>13</td>
<td>43.3%</td>
</tr>
<tr>
<td>Kern</td>
<td>281</td>
<td>91</td>
<td>65.9%</td>
</tr>
<tr>
<td>Los Angeles:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central Juvenile Hall</td>
<td>365</td>
<td>344</td>
<td>63.8%</td>
</tr>
<tr>
<td>Los Padrinos Hall</td>
<td>365</td>
<td>192</td>
<td>47.9%</td>
</tr>
<tr>
<td>San Fernando Hall</td>
<td>365</td>
<td>155</td>
<td>56.0%</td>
</tr>
<tr>
<td>Madera</td>
<td>79</td>
<td>11</td>
<td>36.7%</td>
</tr>
<tr>
<td>Riverside:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Juvenile Hall</td>
<td>346</td>
<td>51</td>
<td>32.5%</td>
</tr>
<tr>
<td>Indio Hall</td>
<td>222</td>
<td>22</td>
<td>44.0%</td>
</tr>
<tr>
<td>San Diego</td>
<td>356</td>
<td>151</td>
<td>68.9%</td>
</tr>
<tr>
<td>Tulare</td>
<td>190</td>
<td>22</td>
<td>36.7%</td>
</tr>
</tbody>
</table>

* Counties with highest incidence of overcrowding.

* Shows the largest number of juveniles by which any daily population exceeded the hall capacity and the percent by which capacity was exceeded.

Overcrowding of juvenile halls is the result of two main factors. First, there is a large number of wards waiting for placement in another facility. According to the CYA’s Statewide Needs Assessment study, 27 percent of the wards currently in juvenile halls are waiting placement in either a foster care placement (14 percent), another county facility (10 percent), or the CYA (3 percent). Although specific data are not available, many county officials have indicated that the length of time a ward spends waiting for placement has been increasing steadily over the past few years as the number of wards incarcerated has increased.

Second, there have been increases in the number of wards committed to juvenile halls for terms of about 30 to 90 days. The problem with this situation is that commitments to the juvenile halls generally conflict with the original intent and design for the halls as very short-term “holding tanks.” The amount of space, the construction of the facilities, and the programs in place in many juvenile halls typically are not suited for wards to stay for any extended period of time. Because of the lack of placement alternatives, however, juvenile halls are being pressed into a service for which they usually are not equipped.

According to probation department staff, juvenile court judges, and the CYA’s study, juvenile halls often are used as a placement option because of the limited space available in the treatment programs. Counties are required by law to operate juvenile halls or contract for bed space in a juvenile hall. This expense is fully funded by the counties. Some county officials we interviewed suggest that once a county pays for the operation of a juvenile hall, there are often few resources left to probation departments for funding “discretionary” programs.
Counties Have Incentives to Use State-Funded Programs

Under the current funding arrangements, the state pays most of the costs of AFDC-FC and CYA placements, and the counties pay most of the costs of placements in county facilities. More specifically:

- **AFDC-FC Program.** The state pays 95 percent (with the counties paying the remaining 5 percent) of wards’ placement costs in about three-fourths of all foster care placements. In the remaining cases, usually involving wards from low-income families, the federal government pays for 50 percent of the placement costs, the state 47.5 percent, and the counties 2.5 percent.

- **CYA.** Commitments to the CYA are funded almost entirely by the state, although the counties reimburse the state $25 per month per ward (about 1 percent of the cost).

- **County Facilities.** The counties currently provide virtually all the support for county camps, ranches, and other local programs that are alternatives to AFDC-FC and the CYA. The Governor’s Budget proposes to eliminate the $37 million that currently is provided by the state for support of local programs and facilities.

This funding arrangement creates fiscal incentives for counties to rely on state-funded programs, rather than their own local programs and facilities. For example, these incentives may explain why admissions of wards to the AFDC-FC programs increased 43 percent from 1984 to 1988, while during this same period juvenile hall and camp populations increased an average of 10 percent. Another, rather unusual example of the counties turning to state-funded programs is the recent conversion of two county camps into AFDC-FC group homes. As a result of this conversion, these camps—which were previously funded entirely by the counties—are now funded almost entirely by the state.

Although the incentives are for counties to place wards in the more expensive state-funded programs, these placements may not necessarily meet the needs of the ward. For instance, a less intensive program than is provided at the CYA may be adequate for some wards charged with property crimes.

By funding the largest share of the most expensive residential programs, and only residential programs, the state is providing fiscal incentives for counties to place wards in state-supported residential care even when some wards could be maintained in less expensive county facilities or nonresidential programs. In other words, counties have no fiscal incentives to control these costs or to seek alternatives to these state-funded out-of-home placements. Conversely, by not sharing in the cost of local programs and placement facilities, the state strengthens the incentive for counties to use foster care and the CYA instead of county programs and facilities.
LEGISLATIVE OPTIONS FOR PROVIDING MORE COST-EFFECTIVE AND BENEFICIAL SERVICES TO JUVENILE OFFENDERS

In our judgment, the Legislature could create incentives for counties to develop a continuum of local placement and treatment options for wards of the juvenile court and also eliminate any fiscal incentives that counties have to place wards inappropriately in state-supported residential care.

In this section we offer several options—grouped under the categories of “AFDC-Foster Care” and the “County Justice System Subvention Program”—for the Legislature to consider as a means to accomplish these ends. Although many of the problems we have discussed and the options we are presenting apply to children who are dependents of the juvenile court as well as to youths who are wards of the court, we have focused this analysis only on wards because of the cross-cutting issues involved by their placement in the foster care system and CYA, as well as in county operated facilities.

A. AFDC-Foster Care

We estimate that the state will spend almost $127 million from the General Fund in the current year for an average daily population of about 4,900 wards in group homes in the AFDC-FC program. The state has a great fiscal incentive to find alternatives to the current level of use of foster care. By developing a continuum of alternative services for wards and eliminating or lessening the fiscal incentives that counties have to rely on state-supported residential care, the Legislature can provide for more appropriate services to wards while controlling state costs for the AFDC-FC program.

Development of Alternatives to Group Home Placements

The Department of Social Services is currently administering a pilot project authorized by Ch 105/88 (AB 558—Hannigan) for juvenile court dependents. The program provides state funds for services to dependents placed at home as an alternative to foster care, while at the same time increasing the counties’ incentives to use successful alternatives.

Given the high level of use of the foster care program by wards, a pilot program of this type for juvenile offenders might be useful. If the Legislature chose to provide a similar program for wards, it would require an investment of General Fund money to provide services specifically to wards who otherwise would be placed in a foster care group home. To the extent that the programs were successful, however, the General Fund could realize savings from the first day of the program’s operation. (This assumes that the services precluded the need for a foster care placement and were less expensive than foster care group homes.) If the cost of the alternatives were the same as the cost of
foster care, the pilot program would have no net impact on General Fund costs. On the other hand, if foster care caseloads were not reduced through the use of alternative services, the General Fund would incur higher costs without realizing any savings.

The counties, however, could be provided with incentives to use these alternatives if they shared some portion of the savings realized through the pilot projects. Because each county's juvenile court (typically relying heavily on probation department recommendations) would be making the placement decisions, counties could also share in the risk assumed by the state in funding these pilots. The counties could do so by providing some portion of the support for the pilots in the event that the projects did not result in reducing the state's costs for the foster care program.

Many local officials and program providers that we interviewed discussed specific programs that could be developed and funded through a pilot project. The following is a discussion of two of the more frequently mentioned alternative programs.

**Enriched Foster Family Homes and Small Family Homes.** Currently, the vast majority of wards placed in foster care are placed into group homes. Wards are placed in these facilities because of the ability of the staff to deal with the various problems associated with specific wards. There are, however, wards who are placed in foster family and small family homes. These facilities house no more than six minors at a time and the environment is more family-like than in a group home. Wards placed in foster family or small family homes usually do not receive the number and type of services as those wards in group homes. As noted above, these homes are reimbursed at a much lower rate than the group homes ($450 a month versus $2,500 a month).

If foster family homes were "enriched" to provide a higher level of service to the wards (for example, counseling and education assistance) and the foster parents (for example, respite care and special training), it is likely that some of the wards now in group homes could be maintained in foster family homes. For these enriched homes to provide a higher level of service than regular foster homes, they would either have to receive a higher rate of reimbursement, with the expectation that they would use these additional funds to purchase services, or they would have to receive additional services from the county or a private agency. However, in order for this option to result in a net reduction in General Fund costs, the costs of the additional services would have to be less than the difference between the existing group homes and family home rates. This should be possible because foster family and small family homes do not incur the staff and administrative costs incurred by group homes.

**Nonresidential Placements.** Another option for a pilot project would be to provide services on a less than 24-hour basis. These “nonresi-
dential” placements currently are funded for a small number of wards by county probation departments when wards need a level of service that is higher than that provided by regular probation supervision and when the wards have families that are stable enough to maintain them at home. This option is generally known as “day treatment.” The basic goal of day treatment programs is to keep a ward occupied with school, vocational education, counseling, or similar activities for eight to ten hours a day. The programs attempt to remove wards from undesirable pressure of peers and neighborhoods while providing services to wards and their families.

Elimination of the Counties’ Incentives to Use State-Supported Residential Care

Under the juvenile justice system, counties are legally responsible for the care and supervision of wards of the court (unless they are placed in the CYA) and for making recommendations to the juvenile courts regarding the decisions for placement. Under the current funding arrangement, however, the counties making the placement recommendations do not have to take into consideration the true costs of the different options. For example, the total cost of county facilities and programs is much less than foster care group home placement, but the costs to the counties of these local options is much greater than the cost of foster care because the local facilities are funded almost entirely by the counties. Conversely, foster care placements are the most expensive placement options available, but are one of the least expensive options available to counties.

The fact that probation departments make placement recommendations without having to address the true cost of the placements creates the fiscal incentive for counties to place wards into foster care rather than in a county-funded program. Historically, the decision of the state to fund most of the foster care costs was based more on county financing issues, rather than on the issue of which ward placements should be preferred over others. The issue of what is the most appropriate treatment setting for wards has been overshadowed by fiscal choices.

In our judgment, a significant adjustment to the current cost sharing ratios is necessary to provide more rational incentives to counties in making placement decisions. In addressing the issue of fiscal incentives and cost sharing, the Legislature would have to carefully construct the share of cost borne by counties and the state to ensure that effective care was provided to wards in the most efficient manner.

B. County Justice System Subvention Program

The CYA’s major local assistance program is the County Justice System Subvention Program (CJSSP). Through this program the Legislature
encourages county probation departments to develop programs that are alternatives to CYA commitments. Below, we examine options to more effectively use these funds by developing local programs that will reduce the number of wards committed to the CYA or provide more cost-effective care.

**Improved Targeting of CJSSP Funds**

Under the CJSSP, the Legislature provides annual General Fund block grants to counties to assist in their funding of the juvenile justice system. In the current year, $67.3 million is budgeted for this purpose. The Governor's Budget for 1989-90 proposes to eliminate $37 million of this amount, and fund the remaining $30 million from the Restitution Fund. The $30 million appropriation would pay for a state-mandated local program involving specific incarceration practices for youthful offenders.

In the current year these funds are *supposed to* be used by the counties to develop and maintain: (1) programs designed to avoid commitment of persons to the Department of Corrections or the CYA; (2) programs for wards who are committed to a county facility; (3) programs for the prevention of delinquency by minors who are not currently wards of the court; (4) programs for home supervision and non-secure facilities and shelter care facilities for minors; and (5) necessary administrative expenses associated with the block grants. According to a study conducted in 1982, the funds provided through the CJSSP at that time did *not* result in the development of new programs or the expansion of existing programs designed to provide the services mentioned above. Instead, the major result was to provide funds needed for the continuation of existing levels of service for both juveniles and adults at the local level in light of the decline in county revenues brought on by Proposition 13. According to CYA staff, this situation remains the same today—the current CJSSP block grants provide funding for the basic services offered by county probation departments.

Despite the way CJSSP funds *have been* used, they *could be* better targeted to achieve one of their intended purposes of reducing CYA commitments. Funds provided to county probation departments or county facilities for local alternatives to the CYA could result in net savings to the state to the extent that: (1) the counties can maintain their current number of camp beds and do not have to rely on the CYA; (2) any new or expanded programs reduce the number of wards committed to the CYA; and (3) the total cost to the state per ward is less in the local programs than in the CYA.

Although the success of the local programs cannot be guaranteed, the Legislature could take steps to assure that CYA commitments are reduced or limited and that any funding provided does not simply result
in an increase in the number of wards removed from home due to the availability of new program space. These steps could include (1) placing some limits on the number and/or type of wards committed to the CYA, and (2) increasing the counties' share of the cost of wards in the CYA to an amount over the currently required $25 per ward per month. This is the amount that was established by law in 1947 when the annual cost of a ward in the CYA was $1,900.

As noted earlier, the current cost of placing a ward in a county camp or ranch is about $11 per day, or $4,000 per year, less than in the CYA. Based on CYA cost data, this difference will grow to about $9,500 annually when and if the CYA realizes its goal of reducing overcrowding to 109 percent of capacity by 1992-93. Therefore, if it were deemed necessary to develop programs that were more intensive and more expensive than existing county camp programs in order to avoid CYA commitments, the Legislature could provide an amount that is substantially less than the CYA costs but still greater than county camp costs. The shorter length-of-stay in county facilities would also help keep down the total costs of such programs. Under these circumstances, the state would realize a net savings.

**Development of Local Probation Programs Would Create a Continuum of Treatment Options**

Targeted CJSSP funds also could be used to develop alternative programs. Many individuals and sources have recommended that the state and counties develop a complete continuum of services for wards in order to: (1) reduce delinquent behavior; (2) avoid removing wards from home when appropriate; and (3) reduce recidivism. This has been the subject of study for many organizations such as the CYA, county probation departments, and advocate groups. The following is a discussion of two programs recommended by juvenile justice professionals and other organizations and individuals who have an interest in attaining these goals.

**Placement Prevention Services.** Currently, most juvenile court decisions result in removal of wards from home. Increased intensive probation services such as counseling, vocational training, and parenting/family skills training could be used to maintain more wards at home. It is the opinion of the probation professionals that we interviewed that if these wards were given more intensive supervision while at home, many of them could avoid a subsequent return to court and removal from home. Placement prevention services are an alternative to placement in a county facility that could be funded through the CJSSP mechanism described above. These are also alternatives to placement in foster care and could potentially avoid eventual CYA commitment.
Independent Living and Parole Programs. The number of wards currently in placement who have been placed previously make up a substantial portion of the current out-of-home population. Table 1 shows that over two-thirds of the AFDC-FC placements and the CYA first commitments have experienced some type of out-of-home placement before. Also, 17 percent of the current CYA population is comprised of wards returned to the CYA institutions for parole violations.

Program providers and juvenile justice professionals indicate that this situation illustrates a need for stronger parole and probation programs at the state and county level. Independent living or “aftercare” programs could be developed to increase wards’ chances of success after release from incarceration or placement. These programs could be funded in the same way as the AFDC-FC related options discussed earlier or as alternatives to incarceration in the CYA discussed above. Currently, there is about $2 million available from the federal Independent Living Program administered by the State Department of Social Services for these programs. The Legislature may wish to consider targeting these funds to address the needs of specific groups of delinquent youths. Funds spent on programs intended to improve wards’ chances of success on parole would be a good investment to the extent that they reduced placement costs associated with wards who violate their parole and are returned to an institution or other placement facility.

Summary

The current methods of treating juvenile offenders are limited, and the current funding arrangements for out-of-home placements do not encourage cost-effective treatments. As a result, wards are not always provided with the best possible treatment, and the state and counties often pay more than is necessary. The Legislature, however, can provide incentives to the counties to use alternatives to the current system as a way of addressing both these concerns.
Trial Court Funding and County Finances

What Effect Will the Trial Court Funding Program Have On the Fiscal Condition of California’s Counties?

Summary

- The Trial Court Funding Program provides fiscal relief to counties by allowing them to use state funding to replace county general fund support for the courts. This frees up general fund revenues, which may be used either to augment court services or to increase funding for other county programs.

- Counties will receive $433 million in funding during the first full year of the program. However, the net increase in revenues available for general purposes will be only $400 million because counties are required to (1) forego previously existing state funding; and (2) shift revenues to “no- and low-” property tax cities.

- To the extent that counties use a portion of the “freed-up” general fund revenues to augment court services, less funding will be available to address county needs in other areas. Based on county/court agreements reported to date, it appears that at least 25 percent of the “freed-up” revenues, and probably more, will be used to increase court services, leaving at most 75 percent of the funding for other purposes.

- If 75 percent of the revenues “freed-up” by trial court funding were available for general purposes in 1989-90, counties would experience about a 3.5 percent increase in discretionary revenues. However, because the amount of funding provided does not necessarily reflect individual county fiscal conditions, some counties may still experience difficulties meeting service needs in the budget year.

- The assistance provided under the Trial Court Funding program could be offset to some extent by other proposals in the 1989-90 Governor's Budget that would have a negative impact on the fiscal condition of counties.

- In the long run, trial court funding is not likely to eliminate county fiscal problems because it does not address the basic structural problem faced by counties: limited growth in revenues and more-rapid cost increases in state-required programs.

- The counties’ lack of fiscal control is likely to (1) limit their responsiveness to local service requirements; (2) exacerbate unmet needs in state-required programs such as health and corrections; (3) unduly influence land use decisions; and (4) hamper their ability to provide the infrastructure needed to accommodate California’s growing population.
In the final days of last session, the Legislature enacted the Brown-Presley Trial Court Funding Act (Ch 945/88). This act generally provides state funding for the trial courts in the form of block grants to counties for court judgeships, commissioners and referees. In addition, the act provides funding for municipal and justice court judges' salaries. The Legislature also enacted Chapter 944, Statutes of 1988, which provides state funding to implement the program during the second half of 1988-89.

The purpose of the Trial Court Funding Program (TCF) is twofold. First, the program seeks to enhance county trial court services by making available an increased level of funding for the Judiciary. Second, the measure attempts to provide some level of fiscal relief to counties by relieving them of a portion of their responsibility for funding trial court services.

In The 1987-88 Budget: Perspectives and Issues (please see p. 245), we described the increasing fiscal pressures counties have experienced since the passage of Proposition 13. We pointed out that levels of service in programs of state concern varied locally, and that there were unmet needs in many programs. The Trial Court Funding Program allows counties to substitute state funding for a portion of the local revenues currently used to support the courts, and to divert the local revenues to address unmet needs in other county programs. As such, trial court funding represents the most substantial fiscal relief measure provided to counties since 1979.

In this piece, we examine the potential effect of TCF on the fiscal condition of California’s counties. We identify the magnitude of the relief counties are likely to receive from this measure, and assess the potential impact of these increased revenues on county fiscal conditions.

Background: The Trial Court Funding Program

The state's court system is defined in the California Constitution, and consists of four separate levels of jurisdiction, as shown in Chart 1. The Supreme Court and the courts of appeal comprise the appellate courts, and the superior courts, municipal courts, and justice courts comprise the state’s trial court system. A portion of the trial court workload (for example, certain arbitration cases or minor violations) is processed by commissioners or referees, rather than judges.
**Prior Funding Arrangements.** Traditionally, the state has had the sole responsibility for funding the operations of the Supreme Court and the courts of appeal. Counties have funded most of the operations of the trial court system, using both court-generated revenues such as fees and fines and county general funds. Over the years, the state has provided assistance to counties for financing of the trial court system. Prior to the passage of TCF, this assistance consisted primarily of funding for a portion of superior court judges' salaries, an annual block grant for certain superior court judgeships, partial payment of certain health and retirement benefits, and payments to reimburse counties for state-mandated programs affecting the operation of the trial courts. In 1987-88, the state's involvement in the funding of local court operations totaled $107 million.

**Description of the Trial Court Funding Program.** The Brown-Presley Trial Court Funding Act substantially increases the state's support for the trial court system. This act provides funding, at county option, in the form of a block grant for each superior, municipal, and justice court judgeship, and for each superior and municipal court commissioner or referee.

The Judicial Council estimates that on average counties pay more than $500,000 per year for each judicial position, including the costs of court staff salaries, operating expenses, and county overhead. The block grant amount, $212,000 in 1988-89, roughly corresponds to these costs, net of the
county share of court-related revenues (for example, traffic and parking violation fees). The grant will increase annually commensurate with the cost-of-living increases received by state employees in the prior year, beginning with a 6 percent adjustment for 1989-90. In the budget year, the block grant amount will be $224,720.

In addition, the act provides for block grants of higher amounts for specified judgeships authorized by Chapter 1211, Statutes of 1987 (SB 709, Lockyer). These payments will begin in 1989. The act also provides for the state to assume approximately 90 percent of the costs of municipal and justice court judges’ salaries.

In order to receive these funds, counties must forego existing block grants for superior court judgeships. Counties also must waive reimbursement for state-mandated local programs for the trial courts, and for any state-mandated local program for which a claim had not been filed prior to the chapter date of the Trial Court Funding Act.

In addition to providing funding for TCF, Chapter 944 requires certain counties to shift a portion of their property tax revenues to cities which currently receive no share or a low share of these revenues. These cities generally are guaranteed a minimum of 7 percent of the property tax revenues within their boundaries. This shift in revenues from the counties to the cities will be phased in over a seven-year period, beginning in 1989-90. Cities in Mono and Ventura Counties will receive a smaller percentage, phased in over a shorter time period.

The Trial Court Funding Act includes two provisions that are designed to ensure that counties maintain or increase the level of funding devoted to the trial courts. First, the act requires counties to maintain the same level of annual funding appropriated for the courts in 1989-90, increased by a factor for inflation. Second, the act requires the superior and municipal court justices to sign the resolution of intent to participate in the program each year. The provision for judicial “sign-off” is designed to ensure that judges have a voice in the allocation of funds received under the program.

Impact on County Finances. The Trial Court Funding Program will affect county finances in two basic ways. First, counties can use TCF to increase the overall level of funding provided for trial courts in order to improve services, reduce backlogs, or address other outstanding needs. Second, counties can use the funding to replace county general fund support for the courts. For example, a county could replace up to $212,000 of its general fund support for each position with state funding, and use the “freed-up” general fund revenues for other county purposes. Similarly, counties could replace the general fund revenues currently used to pay municipal court and justice court judges’ salaries with state funds, and divert the county funds for other purposes.
How Much Relief Will Counties Receive?

A total of 56 counties (all except Madera and Santa Barbara Counties) opted into TCF in 1988-89. The Department of Finance estimates that these counties will receive about $200 million for the first one-half year of funding. The Governor's Budget estimates that counties will receive $433 million under the Trial Court Funding program in 1989-90, assuming that all 58 counties participate. (As discussed in Item 0450 of the Analysis (please see p. 24), the Legislature will not know until March 1 how many counties will opt into the program for 1989-90.)

Our analysis indicates, however, that TCF will "free-up" about $400 million in county revenues, as shown in Chart 2. First, the requirement that counties forego judicial block grants and waive reimbursement for the costs of certain court-related mandates reduces the net benefits from the measure by approximately $26 million in 1989-90. Second, the required shift of property tax revenues to "no-and-low" property tax cities will reduce the benefits received by the 16 counties required to make this shift. While this shift in revenues is relatively minor in 1989-90 (probably less than $5 million), it will increase substantially over the phase-in period. We do not have sufficient information to determine the precise amount of revenue to be shifted from counties to cities, but we estimate that this amount will be in the range of $100 million by 1997-98.

---

**Chart 2**

**Effect of Trial Court Funding on County General Fund Revenues 1989-90**

<table>
<thead>
<tr>
<th>Effect on Revenues</th>
<th>1989-90 (dollars in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>State provides judicial block grants</td>
<td>$386</td>
</tr>
<tr>
<td>State pays municipal and justice court judges' salaries</td>
<td>47</td>
</tr>
<tr>
<td><strong>Minus</strong></td>
<td><strong>Minus</strong></td>
</tr>
<tr>
<td>Counties relinquish existing judicial block grants</td>
<td>-14</td>
</tr>
<tr>
<td>Counties waive reimbursement for court-related mandates</td>
<td>-12</td>
</tr>
<tr>
<td>Sixteen counties shift property tax revenues to &quot;no-and-low&quot; tax cities</td>
<td>Up to 5</td>
</tr>
<tr>
<td><strong>Equals</strong></td>
<td><strong>Equals</strong></td>
</tr>
<tr>
<td>Counties spend remainder on:</td>
<td>$400</td>
</tr>
<tr>
<td>- Increased court expenditures</td>
<td>(At least 100)</td>
</tr>
<tr>
<td>- Increased spending on other programs</td>
<td>(Up to 300)</td>
</tr>
</tbody>
</table>

*Source: Legislative Analyst estimates.*
How Will Counties Use the Revenues “Freed-Up” By TCF? It is too early yet to determine the split of funding between increased court expenditures and other county programs. Because judicial “sign-off” is required to participate in the program, judges and county supervisors in each county are expected to come to a formal agreement over the allocation of revenues “freed-up” by TCF. Our review of county/court agreements reported by 27 counties suggests that there will be substantial variation in the amount of funding allocated for increased court expenditures versus other programs.

In a number of counties, the agreements provide for large increases in spending on the courts and court-related programs. For example, in 1989-90, Los Angeles County has agreed to provide $38 million (29 percent) of its net TCF monies to increase trial court services, and an additional $45 million (35 percent) to increase other court-related programs. Of the $30 million San Diego County expects to be freed-up in 1989-90, the county has agreed to use approximately $18 million (60 percent) to increase spending on the courts and court-related programs. Kern County is planning to spend almost 50 percent of the revenues freed-up in 1988-89 to augment court services (the county has not yet opted in for 1989-90).

Other counties plan to use a relatively large share of their freed-up revenues for programs other than the courts. For example, in 1988-89, Alameda County plans to use about 90 percent of the freed-up revenues for general purposes. Merced County has a tentative agreement for 1989-90 which would allow the county to use about 84 percent of the revenues for programs other than the courts. Many of the smaller counties have not earmarked the funding for any purpose, and plan to determine the use of the funds during their 1989-90 budget debates.

Our review of county/court agreements and our discussions with county officials indicate that it is reasonable to assume that at least 25 percent of freed-up revenues, and probably more than this amount, will be used to increase trial court expenditures on a statewide basis. Thus, counties are likely to use at most 75 percent of the freed-up revenues for general purposes (rather than increased court spending).

Impact on County Budgets

Assuming that counties are able to spend 75 percent of the revenues freed-up by TCF on programs other than the courts, they could increase spending in other program areas by about $300 million in the first full year of the program (1989-90). Comparing this to our estimate of county general purpose revenues in 1989-90, this represents an increase of about 3.5 percent in their general purpose revenue base. While this appears at
first glance to be a small relative change, it is equivalent in magnitude to about 50 percent of the increase in county general fund revenues expected to occur in 1989-90. Thus, Trial Court Funding will result in a substantial “bump” in the revenues available for general purposes.

**County Gains Reduced by Budget Proposals.** Our analysis indicates, however, that the impact of TCF on county budgets would be offset to some extent in 1989-90 by reductions in other local assistance programs proposed in the 1989-90 Governor’s Budget. These include:

- **Mandate Repeal Proposal.** The administration proposes to repeal 27 mandated programs in lieu of providing reimbursements estimated at $43.5 million for 1989-90. The budget indicates that if the Legislature rejects this proposal, the Governor will reduce state assistance to counties by a corresponding amount.

- **In-Home Supportive Services.** The Governor proposes to reduce funding for the In-Home Supportive Services (IHSS) program by approximately $64 million in 1989-90. This would be accomplished by placing a cap on the average number of hours per case in each county and by limiting the reimbursement rate paid to service providers. It may not be possible for the state to save money in the long run by limiting the rate of reimbursement to providers. This is because it is possible that the rate will not attract enough providers to cover all of the hours of service needed by recipients. In this event, the state would either have to raise the rate, or allow recipients to go without needed services. In the latter case, some counties might respond by providing increased rates at county expense.

- **Medically Indigent Services Program.** The budget proposes to replace $359 million in General Fund support for the Medically Indigent Services Program (MISP) with Proposition 99 revenues ($331 million) and federal State Legalization Impact Assistance Grant (SLIAG) funds ($100 million). Although this proposal is intended to increase overall funding levels for this program, it is likely to have a negative impact on counties over time, for three reasons. First, counties are likely to experience difficulty claiming SLIAG funding due to the reluctance of program participants to document their immigrant status. As a consequence, they may find it necessary to replace this support with county general fund revenues. Second, SLIAG funding expires in 1991-92, and the cigarette and tobacco tax revenues provided by Proposition 99 are a declining revenue source. Thus, there is some likelihood that counties will be required to take on an ever-larger share of funding for the program over time. Third, although statewide the budget proposal may result in an increased level of funding for indigent health care, some counties are expected to experience net revenue losses, due to
differences in the existing and proposed funding allocation formulas for MISP, Proposition 99 and SLIAG.

**TCF DOES NOT SOLVE LONG-TERM COUNTY FISCAL PROBLEM**

While TCF will provide fiscal relief to counties, our analysis indicates that it is unlikely in the long term to eliminate the fiscal problems experienced by counties, for two reasons. First, because the amount of funding provided is not targeted to take into account variations in local fiscal health, some counties are likely to experience continuing difficulty meeting local service demands. Second, TCF is unlikely to solve the fundamental fiscal problem faced by counties: the disparity between growth in uncontrollable costs and growth in general purpose revenues.

**Variations in County Fiscal Conditions and TCF Relief**

As noted earlier, counties could receive up to $300 million statewide under TCF for general purposes. Although this is a significant revenue increase, the actual impact will vary between the counties. This is because there will be substantial variations in the amount of TCF received by each county, just as there are substantial variations in local fiscal conditions.

As discussed above, the amount of trial court funding provided to counties depends on the number of judicial positions in each county’s trial courts. Although this number would tend to reflect local demands on the courts, it may bear little relationship to local fiscal conditions. Thus, the amount provided is unlikely to reflect other cost pressures experienced by the counties or their varying abilities to raise revenues locally. Because trial court funding is not targeted to take into account individual county fiscal conditions, some counties may find that the funding provided closes the gap between revenues and service demands, while in other counties it will make a less significant contribution.

Information is not available at this point to assess the program’s effect on each county’s budget. However, a number of counties in which the bulk of the “freed-up” revenues will be used for county general purposes report that they nevertheless expect to have difficulties balancing their budgets in 1989-90. For example, Merced County expects that an additional $5 million would be required to maintain current service levels, even after taking into account trial court funding. San Francisco County expects a substantial funding shortfall in 1989-90, and Yolo County has reported a current services shortfall of approximately $2 million for next year. Other counties report that the freed-up revenues provided by trial court funding will not cover their increased costs of operating county hospitals or jails. Thus, although trial court funding provides a substantial amount of funding statewide, the program is unlikely to eliminate each county’s fiscal troubles.
Structural Budget Problem Will Erode Gains

As we described in The 1987-88 Budget: Perspectives and Issues, counties have experienced rapid growth in expenditures for state-required programs and more moderate growth in county revenues. As a consequence, counties have found it increasingly difficult to fund both the programs required by state law and the traditional programs desired by their citizens. Table 1 presents estimates of the level of revenues available to counties for general purposes between 1985-86 and 1987-88, the most recent years for which data are available. In addition, the table shows the growth of county expenditures for certain programs required by state law. Comparison of the two growth rates gives an indication of whether or not the amount of funds “left over” for local needs is expanding or contracting.

Table 1
County General Purpose Revenues and Expenditures for State-Required Programs a
1985-86 through 1987-88
(dollars in millions)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>General purpose revenues</td>
<td>$6,497</td>
<td>$6,803</td>
<td>$7,321</td>
<td>12.7%</td>
</tr>
<tr>
<td>Expenditures</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State-required programs:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health and welfare</td>
<td>919</td>
<td>996</td>
<td>1,100</td>
<td>19.6</td>
</tr>
<tr>
<td>Trial courts</td>
<td>909</td>
<td>1,001</td>
<td>1,092</td>
<td>20.2</td>
</tr>
<tr>
<td>Jails</td>
<td>674</td>
<td>792</td>
<td>837</td>
<td>24.3</td>
</tr>
<tr>
<td>Subtotals</td>
<td>($2,502)</td>
<td>($2,759)</td>
<td>($3,029)</td>
<td>(21.1%)</td>
</tr>
<tr>
<td>All other programs</td>
<td>$3,995</td>
<td>$4,044</td>
<td>$4,292</td>
<td>7.4%</td>
</tr>
<tr>
<td>Real per-capita spending on all other programs b</td>
<td>$152</td>
<td>$146</td>
<td>$145</td>
<td>-4.0%</td>
</tr>
</tbody>
</table>

a Source: Legislative Analyst estimates. Detail may not add to totals due to rounding.

In the long run, our review indicates that the structural problem experienced by counties will continue, for two reasons: (1) counties do not have control over any major independent revenue source; and (2)
counties have difficulty controlling the growth in costs for state-required programs such as health, welfare and jails. These factors are discussed in more detail below.

**Revenue Growth Limited.** Prior to Proposition 13, counties could increase the property tax rate to raise the revenues needed to fund both the programs desired by their citizens and the services required by state law. Under Proposition 13, however, counties do not have control over any major independent financing source. Therefore, as service needs increase, counties have difficulty generating the funds required to address these needs.

The Legislature has taken actions in recent years to increase the level of funding available to counties; however, these actions appear to have had a limited impact on county revenues. For example, Chapter 1257, Statutes of 1987 (AB 999, Farr), allows counties with populations under 350,000 to increase their sales tax by one-half cent, with voter approval, for general purposes. While 16 counties have proposed sales tax increases under this law, only one of these measures has passed. Because voters are seemingly reluctant to approve a new or increased sales tax for general purposes, this revenue authority has had a limited effect on county fiscal conditions. Moreover, this option is not available to larger counties, many of which are also experiencing fiscal difficulties.

In addition, the Legislature enacted Chapter 1286, Statutes of 1987 (AB 650, Costa). This act provided counties a one-time block grant of $113.7 million in 1987-88. In 1988-89 and subsequent years, Chapter 1286 provides funding to stabilize the percentage of county general purpose revenues which must be expended for the county share of costs associated with four state programs (mental health, AFDC, IHSS and food stamps). Specifically, if a county’s ratio of costs for the four programs to its general purpose revenue is higher in a particular year than it was in 1981-82, the state will provide increased assistance to offset the difference. Chapter 1286 limits the amount appropriated for these purposes to $15 million per year. Initial estimates by the Department of Finance, however, indicate that this amount will not be adequate to fully stabilize county spending on these programs in 1989-90. Thus, while Chapter 1286 provides some relief to the most distressed counties, its impact on their basic structural problems is limited.

**Health Service Costs.** Welfare and Institutions Code Section 17000 requires counties to be the “provider of last resort” with regard to indigent health care. The state helps the counties fulfill this responsibility through (1) the Medically Indigent Services Program, and (2) provision of matching funds under the County Health Services program (AB 8).

In recent years, the counties have shouldered an increasing share of funding for indigent health care services. County funding for the health
services “safety net” was $334 million in 1987-88, an increase of 30 percent over 1985-86. Counties will feel pressure to increase expenditures for health care services in the future, due to a number of factors. These include capital needs for health-related facilities, increasing reliance on costly trauma systems, and the growing burden of the AIDS crisis. In addition, recent court cases have required counties to increase their health services costs (for example, by providing dental and prenatal services to indigents).

**Public Assistance Costs.** County costs for public assistance in 1987-88 were $650 million, an increase of 14 percent over 1985-86. This was due, in part, to actions by the courts and the state which expanded county responsibilities to provide for the poor. For instance, through General Assistance programs, counties provide aid to individuals who do not qualify for benefits under AFDC. In recent years, the courts have systematically increased county expenditures under this program. For example, recent court decisions have required some counties to match AFDC benefit levels, and have prohibited the use of a permanent address requirement in determining eligibility.

Counties also are likely to experience future increases in other public assistance program costs. For example, county officials report that they have recently experienced dramatic increases in demand for their Adult Protective Services (APS), which responds to reports of dependent adult or elder abuse. Counties expect additional program cost increases in the future due to the aging of California’s population and to increased social awareness of the problem of adult abuse.

**County Jail Costs.** Counties traditionally have funded both the construction and operating costs of county jail systems. In recent years, county jail populations have increased dramatically, due to such factors as population growth, higher incarceration rates and increased lengths of stay. The average daily population in county jails went from 44,106 in 1984 to 60,802 in 1987, an increase of 38 percent, resulting in jail overcrowding in many counties. The Board of Corrections reports that, in 1987-88, 95 percent of all prisoners housed in county jails were detained in overcrowded facilities. In many counties, the courts have responded to these problems by imposing jail population caps. As a consequence, counties face increasing costs for both construction and operation of county jails.

Since 1981, the voters have approved four bond measures providing a total of $1.4 billion to counties for jail construction. These increases in jail capacity have resulted in increased county costs for jail operation. Between 1985-86 and 1987-88, county costs for jail operations increased approximately $160 million, or 24 percent.

**Benefits of TCF Erase Over Time.** In sum, county costs for certain programs have grown at a faster pace than county revenues, and are
likely to continue this trend in the future. The Trial Court Funding Program does not eliminate this problem because the funding is unlikely to keep pace with the cost increases faced by counties. County costs for state-required programs recently have increased at a rate of about 10 percent per year. The grants provided under TCF will grow at a much slower rate—the annual increase in state employee salaries. Therefore, it is likely that the benefits of TCF will erode over time.

**Implications of County Fiscal Distress**

Given the disparate growth rates between county revenues and state-required programs, counties probably will continue to spend an increasing share of the local dollar on state-required services. This basic lack of local fiscal control has several consequences:

- Counties lack the flexibility to respond to local needs in discretionary services. In response to diminished local revenues, many counties recently have curtailed spending on a variety of services. Counties report having closed libraries and park facilities, discontinued recreational programs, and reduced hours in county offices.

- As mentioned in our discussion of accommodating growth in California (please see p. 97), the need to increase local revenues may have an undue influence on local land use decisions. Because counties receive a relatively high amount of revenues from industrial and commercial development, they have an incentive to encourage growth of this type in unincorporated areas of the county, even in cases where such land uses produce other adverse impacts.

- The counties' struggle with conflicting priorities has resulted in service levels in major programs varying tremendously from county-to-county. For example, in response to fiscal pressures, some counties appear to have restricted growth in probation services, despite the high growth in the probation population. This has generally led to increasing probation officer caseloads, and in many counties has led to the elimination of direct supervision of persons placed on probation. In addition, as we discussed in *The 1988-89 Budget: Perspectives and Issues* (please see p. 93), there appear to be growing unmet health services needs in many counties. The significant variation in these program service levels has been a concern to the Legislature.

- The counties' revenue constraints may hamper their ability to respond to future infrastructure needs. Many counties have responded to funding shortfalls by delaying investment in infrastructure projects such as road construction or maintenance. As we point out in our earlier discussion of growth management, and in our recent report, *A Perspective On The California Economy*, adequate investment in transportation systems, waste management systems and other infrastructure projects is vitally necessary to ensure that
California can accommodate its rapidly growing population. Much of the responsibility for providing this type of infrastructure falls to counties, who may have trouble funding such projects.

**Conclusion**

The Trial Court Funding Program represents the most significant county relief measure enacted since 1979. This program provides counties badly needed assistance by freeing up general purpose revenues that would otherwise be spent on the courts. However, because the amount of relief provided does not necessarily reflect variations in county fiscal conditions, some counties are likely to experience continuing difficulties accommodating current demands. Moreover, in the long term, the relief provided by TCF is likely to erode as increases in the costs of health services, public assistance and corrections exceed county revenue growth.
The Electrical Generation Industry in the 1990s

Should the Legislature Reconsider the Way it Regulates the Electrical Generation Market?

Summary

- The electric utility industry performs three basic functions: generation of electricity, long distance transmission and local distribution. Most utilities provide all three functions within exclusive service areas, and have been heavily regulated by the state as "natural monopolies."
- In recent years, federal laws designed to encourage nonutility electrical generating capacity, along with technological and other changes have shown the potential viability of a competitive electricity generation market.
- In light of these changes, we recommend that the Legislature undertake a thorough review of the state's regulation of electricity generation, with the objective of encouraging the development of a competitive market.
- Specific elements of this review could include: (1) moving from capacity bidding to market pricing of electricity, (2) considering limiting future utility ownership of generating capacity, (3) addressing the transmission access problem, (4) considering phasing out Energy Commission siting functions, and (5) changing the nature of the Energy Commission's electricity forecasts.

In 1978, the federal Public Utilities Regulatory Policy Act—known as PURPA—was enacted to encourage utility rate reforms and to require utilities to buy electricity at fair prices from small power producers. PURPA helped trigger a significant transformation of the electricity generation market in California from a utility-based system driven by larger generation facilities to a more diversified system that allows for smaller facilities and greater opportunities for nonutility power producers. Despite the changes in the industry, the state still approaches the economic regulation of utilities in much the same way that it always has. The Legislature, in looking to the 1990s, should reexamine its current regulatory structure in order to accommodate these new economic realities.

In this analysis, we provide background on the electrical generation industry in the state, examine the state regulation of the industry, and offer several steps the Legislature could take to move the state toward an alternative way of regulating the industry in the 1990s and beyond.
PROFILE OF THE CALIFORNIA ELECTRICITY GENERATION MARKET

There are three basic stages in the production and distribution of electricity. These are (1) generation of electricity (such as natural gas-fired, or hydro power plants), (2) large volume, long distance transportation of electricity from generating plants to local markets ("bulk power" transmission), and (3) retail distribution of electricity to customers within local markets (local power lines, meters, and utility service). Most utilities are "vertically integrated," meaning that they are involved in two or more stages of production.

There are basically two types of utilities providing these services; (1) investor-owned utilities (IOUs), such as Pacific Gas & Electric (PG&E); and (2) publicly owned utilities (POUs), which are composed of municipal utility districts (such as Sacramento Municipal Utility District), utility departments of local governments (such as Los Angeles Department of Water and Power) and rural electric cooperatives. All utilities have exclusive franchises to operate at the local distribution level.

Prior to the early 1960s, California IOUs were largely self-sufficient and imported power only from Hoover Dam on the Colorado River. The POUs primarily bought power from the IOUs or produced small quantities of hydro power. The bulk power transmission system within California originally was used primarily by the IOUs to facilitate sales to POUs and to trade power between adjacent utilities to compensate for differences in peak power needs and generating plant outages. Over time, bulk power transmission capacity was constructed to allow for the purchase of electricity from both the Pacific northwest and the southwest. These and other links created what has become an eleven state regional bulk transport system for moving electricity throughout the entire western United States.

Recent Changes in the Production of Power

PURPA created a market for nonutility power producers (known collectively as small power producers or "PURPA facilities") by requiring utilities to purchase electricity produced by these companies. At about this same time, another type of nonutility producer—known as independent power producers (IPPs)—also began to sell power from their plants to utilities. IPPs differ from the small power producers and utilities in that they build larger, non-PURPA facilities and are not as heavily regulated as utilities.

In response to these nonutility power producers, IOUs began to establish unregulated subsidiaries (for example, Mission Electric owned by Southern California Edison) and joint ventures with engineering firms (for example, PG&E's joint venture with Bechtel Corporation) to build unregulated generating plants, sometimes within their own retail fran-
chise area. There also have been proposals to spin off existing regulated generating capacity into separate unregulated companies.

In addition to the impact of nonutility producers on the market, there were other forces at work changing the electricity generation market. For instance, the oil cost and availability problems in the 1970s precipitated research into and development of new generation technologies—such as new ways of burning coal, wind and solar power, and cogeneration. Additionally, forecasts of rapid electricity demand growth were replaced in the late 1970s by far more modest demand forecasts. Also important in shaping the market in the 1980s were cost overruns for and environmental concerns about large utility-owned power plants (primarily nuclear, coal- and oil-fired), which led to marked reluctance by utilities—both IOUs and POUs—to build such plants.

Other institutional changes shaping today's market include: (1) joint powers agreements by POUs to spread the construction and operating costs of powerplants or transmission lines; (2) consortiums of IOU's and POUs to build bulk power transmission projects; and (3) regional power pools to coordinate bulk power transfers between utilities and assure reliability of the transmission system.

Electricity Generation Market Today

The electrical generation industry is large and diverse. Peak electricity demand in California could reach more than 51,000 megawatts (MW) in 1989, based on preliminary staff estimates used to prepare the California Energy Commission's (CEC) 1988 Electricity Report (draft). The peak demand represents the highest instantaneous demand measured in the state. Most of the time demand is below this level; however, utilities must have resources available to meet this instantaneous demand or the system could fail, leading to black outs. Alternatively, the utilities would have to implement selective curtailments to ration available capacity. Electricity to meet this demand is provided by a mix of generating facilities that include hydro, nuclear, oil-fired, gas-fired, wind, geothermal, biomass and solar.

The demand for electricity in California is met from a variety of sources:

- **Utility Generators.** Table 1 provides summary information about the ownership of generating capacity by utilities and certain public agencies within California. While the five major utilities dominate the generation market, it is clear that there are many producers who participate.


Table 1
Utility and Public Agency Generating Capacity (megawatts)

<table>
<thead>
<tr>
<th>Utility</th>
<th>Thermal Capacity</th>
<th>Hydroelectric Capacity</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anaheim Municipal Utility District (MUD)</td>
<td>235</td>
<td>-</td>
<td>235</td>
</tr>
<tr>
<td>Azusa MUD</td>
<td>2</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>Banning MUD</td>
<td>2</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>Burbank MUD</td>
<td>306</td>
<td>-</td>
<td>306</td>
</tr>
<tr>
<td>City of Santa Clara MUD</td>
<td>245</td>
<td>5</td>
<td>250</td>
</tr>
<tr>
<td>Calaveras County Water District</td>
<td>-</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>City and County of San Francisco</td>
<td>-</td>
<td>274</td>
<td>274</td>
</tr>
<tr>
<td>Colton MUD</td>
<td>2</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>Department of Water Resources</td>
<td>266</td>
<td>206</td>
<td>472</td>
</tr>
<tr>
<td>East Bay MUD</td>
<td>-</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Glendal MUD</td>
<td>290</td>
<td>-</td>
<td>290</td>
</tr>
<tr>
<td>Los Angeles Department of Water and Power</td>
<td>5,176</td>
<td>1,273</td>
<td>6,449</td>
</tr>
<tr>
<td>Merced Irrigation District</td>
<td>-</td>
<td>79</td>
<td>79</td>
</tr>
<tr>
<td>Metropolitan Water District of Southern Calif</td>
<td>-</td>
<td>72</td>
<td>72</td>
</tr>
<tr>
<td>Modesto Irrigation District c</td>
<td>154</td>
<td>45</td>
<td>229</td>
</tr>
<tr>
<td>Nevada Irrigation District</td>
<td>-</td>
<td>73</td>
<td>73</td>
</tr>
<tr>
<td>Northern California Power Agency</td>
<td>229</td>
<td>-</td>
<td>229</td>
</tr>
<tr>
<td>Oakdale and Southern San Joaquin Irrigation District</td>
<td>-</td>
<td>77</td>
<td>77</td>
</tr>
<tr>
<td>Oroville-Wyandotte Irrigation District</td>
<td>-</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td>Pasadena MUD</td>
<td>293</td>
<td>15</td>
<td>308</td>
</tr>
<tr>
<td>Pacific Gas &amp; Electric</td>
<td>11,124</td>
<td>3,661</td>
<td>14,785</td>
</tr>
<tr>
<td>Placer County Water District</td>
<td>-</td>
<td>227</td>
<td>227</td>
</tr>
<tr>
<td>Redding MUD c</td>
<td>22</td>
<td>1</td>
<td>23</td>
</tr>
<tr>
<td>Riverside MUD</td>
<td>172</td>
<td>-</td>
<td>172</td>
</tr>
<tr>
<td>Southern California Edison</td>
<td>14,473</td>
<td>1,143</td>
<td>15,616</td>
</tr>
<tr>
<td>San Diego Gas &amp; Electric</td>
<td>2,798</td>
<td>-</td>
<td>2,798</td>
</tr>
<tr>
<td>Sacramento MUD</td>
<td>986</td>
<td>659</td>
<td>1,645</td>
</tr>
<tr>
<td>Solano Irrigation District</td>
<td>-</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Turlock Irrigation District</td>
<td>48</td>
<td>111</td>
<td>159</td>
</tr>
<tr>
<td>U.S. Bureau of Reclamation</td>
<td>-</td>
<td>1,006</td>
<td>1,006</td>
</tr>
<tr>
<td>Vernon MUD</td>
<td>33</td>
<td>-</td>
<td>33</td>
</tr>
<tr>
<td>Yuba County Water Agency</td>
<td>-</td>
<td>286</td>
<td>286</td>
</tr>
</tbody>
</table>

Totals                                       | 36,856           | 9,320                  | 46,176|

a These include oil-, coal-, and gas-fired plants and nuclear and geothermal facilities.
b Capacity estimates are those developed by CEC staff and represent electricity generating capacity available during relatively dry hydro years.
c Includes entitlements to capacity from a New Mexico plant (San Juan 4) that these MUDs are not currently able to import to their service areas.
d Of this total about 5,000 MW represents long-term entitlements to power from or ownership in plants located outside California, primarily in the Southwest.
e Total is not adjusted for transmission system and other losses.


- **Nonutility Generating Capacity.** Table 2 provides an overview of nonutility generating capacity available to California utilities. The plants shown generally are operating under PURPA contracts. Together, these plants represent capacity of about 5,300 MW. These plants are owned and operated by a wide variety of independent energy companies, manufacturers and food processors, and unregulated subsidiaries of utility holding companies.
Table 2
Nonutility Generating Projects
By Region and Type of Plant
(megawatts)

<table>
<thead>
<tr>
<th>Type of Plant</th>
<th>Region</th>
<th>California</th>
<th>So. California</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cogeneration</td>
<td></td>
<td>1,201</td>
<td>2,093</td>
<td>3,294</td>
</tr>
<tr>
<td>Biomass</td>
<td></td>
<td>124</td>
<td>14</td>
<td>138</td>
</tr>
<tr>
<td>Landfill/digestor gas</td>
<td></td>
<td>37</td>
<td>73</td>
<td>110</td>
</tr>
<tr>
<td>Wind</td>
<td></td>
<td>643</td>
<td>614</td>
<td>1,257</td>
</tr>
<tr>
<td>Small Hydro</td>
<td></td>
<td>101</td>
<td>107</td>
<td>208</td>
</tr>
<tr>
<td>Solar</td>
<td></td>
<td>7</td>
<td>112</td>
<td>119</td>
</tr>
<tr>
<td>Geothermal</td>
<td></td>
<td>81</td>
<td>131</td>
<td>212</td>
</tr>
<tr>
<td>Municipal solid waste</td>
<td></td>
<td>—</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>2,194</td>
<td>3,154</td>
<td>5,348</td>
</tr>
</tbody>
</table>

* Of this total, about 2,010 MW is subject to California Energy Commission siting review.

- **Utility Company Power Purchase Contracts.** In addition to generating plants, both IOUs and POUs in California purchase large quantities of power from out-of-state utilities and federal marketing agencies (including Bonneville Power Administration and US Bureau of Reclamation, Colorado River projects). These contracts represent the equivalent of about 4,100 MW of capacity.

Not only is there a large, diverse number of generating sources, but they currently provide a considerable amount of excess generating capacity. We estimate this statewide excess capacity to be about 4,500 MWs. While the CEC estimates that electricity demand in California will grow at about 2.1 percent annually through 1999, the commission also projects that most of this growth can be accommodated by existing generating plants, purchase contracts and planned conservation and load management programs. Hence, the commission expects that relatively few new plants will have to be built over the next 10 years to accommodate expected demand growth.

While these estimates are reasonable, there are some cautionary notes:

- **Demand Forecast Uncertainties.** Current CEC forecasts show increased projected demand growth rates for the first time in many years. If growth rates are higher than projected, then the excess capacity would dissipate more rapidly than currently is expected.

- **Diversity Among Regions.** Statewide estimates of overcapacity mask diversity among individual local utility service areas. For example, while it is unlikely that PG&E would need additional capacity until well into the 1990s, San Diego Gas & Electric currently has little excess capacity.
• Environmental Regulation on Plant Closures. Overall capacity totals also mask potential powerplant closures that could occur as a result of recent state Clean Air Act amendments (Ch 1568/88—AB 2595, Sher). The act gives air quality districts additional authority to require the retrofitting of certain oil- and gas-fired plants with the best available pollution control technology. Given the expense of retrofitting, many of these old plants could be forced to close within the next few years. Current estimates are that somewhat over 700 MW could be eliminated by these requirements.

Importance of the Bulk Power Transmission System to the Generation Market

As noted above, the bulk power transport system serves several important functions. It: (1) allows electricity to be transported long distances from large generating plants to consumers, (2) helps utilities trade power to balance short-run supply and demand and meet backup power needs, and (3) is used by nonutility producers of electricity to transport the power they produce to the utilities with whom they contract.

Any large system that includes many sources of electricity generation requires considerable technical coordination in order to move electricity efficiently to local distribution companies. Historically, the utility companies that owned transmission capacity provided this coordination function. As utilities began to purchase electricity from sources located farther from their service areas, they found they had to develop more formal arrangements to coordinate the transmission system. In some regions of the country, all electricity that moves across the bulk power transmission system is controlled from a central agency created by the utilities to provide that function. While similar institutions have developed in the west, western utilities have retained more control over electricity sales that involve the use of their transmission capacity.

The Federal Energy Regulatory Commission (FERC) currently is engaged in a two-year marketing experiment that involves most of the major western utilities and federal power marketing agencies. The objective of the experiment is to determine the feasibility of a competitive market in wholesale electricity. In essence, FERC is trying to develop information about: (1) the ability of utilities and electricity producers to buy and sell power using prices that reflect short-run changes in supply and demand (these prices are known as “spot prices”), and (2) the ability of coordinating agencies to set prices for transmission services and oversee the reliability of the bulk power transmission system.
THE REGULATION OF THE ELECTRICITY GENERATION INDUSTRY

Currently, California's electric utility industry is heavily regulated. In this section we examine the basis for this regulation, review the public agencies involved in regulating the electric industry, and analyze how changes in the industry are undermining the historical basis for regulation.

Why Regulate the Electric Generation Market?

Economic regulation is that set of policies adopted by government to control and oversee the structure and conduct of an industry for the benefit of all segments of society. Such regulation can involve the approval of prices, the control of entry of firms into the market, and the setting of other market conditions. Generally, economic regulation of an entire industry (like power production) is necessary only in cases of "market failure." In the case of the electric utility industry, regulation has been justified on two main bases:

- **Natural Monopoly.** Some have argued that the appropriate size of an efficient utility is so large that a market would only allow for one or at most a few firms. This argument also assumes that the industry is subject to substantial economies of scale and that barriers to entry at this stage are large. Thus, vertically integrated firms already in the industry could resort to various strategies to either prevent entry or drive out less advantaged competitors. The result would be an industry with few firms and the ability to reduce output and raise prices relative to a competitive market.

- **Quality of Service.** Because of the nature of bulk power transmission and local distribution systems, there are many technical requirements that power plants must meet in order to maintain the integrity of the system. These include the ability to maintain technical specifications and balance demand and supply virtually instantaneously. Together, these are known as reliability requirements. Some argue that these requirements would be difficult or impossible to meet in a competitive market. In effect, they argue that vertically integrated, monopoly firms are needed to protect and maintain control over the system.

While regulation can compensate for these failures, it is widely accepted that regulation also imposes costs on society. These costs include: (1) the expense of the regulatory process, (2) inefficiencies in the use of capital and other inputs to the production of services, and (3) inefficiencies due to retail prices that do not reflect true costs.
Current Regulatory Process

Currently, California's utilities are regulated primarily by three state and federal agencies:

- **CEC.** The California Energy Commission's regulatory responsibilities include: (1) creating state energy plans, (2) certifying most thermal power plant construction, (3) determining long-term electricity demand and supply, (4) developing energy efficiency standards for buildings, and (5) fostering new, less oil-dependent and more environmentally sound energy sources.

- **PUC.** The California Public Utilities Commission is involved in the day-to-day regulation of investor owned utilities. The PUC has no authority over POUs (except to the extent it serves as the lead agency for California Environmental Quality Act oversight of transmission line projects that involve both IOUs and POUs as partners). The regulatory activities of the PUC include (1) setting rates paid by IOU customers, (2) auditing the performance of companies, (3) determining the prudency of IOU investments (including generating facilities) and power purchase contracts, and (4) investigating industry conditions for the purposes of developing regulatory policy.

- **FERC.** The Federal Energy Regulatory Commission has regulatory authority over: (1) wholesale pricing of interstate electric power sales, (2) certification of need for interstate transmission line projects, (3) setting rates for, and conditions of access to, interstate bulk transmission of wholesale power, and (4) rulemaking pursuant to implementation of PURPA.

Publicly owned utilities receive general policy guidance from the Legislature; however, they are not directly regulated at the state level. Rather, they are regulated either by locally elected boards or by the local government of which they are a part.

**The PUC's Role in PURPA Implementation.** To implement PURPA in California, the PUC developed a series of four contracts (known as "interim standard offers") that small power producers could use when negotiating with utilities for power purchase agreements. Certain of these contracts provided very lucrative long-term pricing for the electricity these small power producers sold to utilities, as electricity prices were based on historically high natural gas prices. A stampede to obtain utility contracts ensued, and up to 15,000 MW of capacity (representing almost one-third of current peak demand) were committed to long-term contracts before the PUC terminated these interim standard offers. Of these contracts, however, about 10,000 MW are not currently under development and should expire by April 1990.

The PUC, in a series of proceedings lasting several years, modified both the contracts and the contracting procedures in an attempt to eliminate
future excess capacity problems caused, in part, by initial PURPA implementation. Additionally, the PUC's intent is to enhance the prospects for development of a more efficient, competitive electricity generating market. The approach chosen by the PUC was to develop a biennial bidding program to allocate estimated capacity needs among all parties—utilities and nonutilities—interested in supplying generating capacity. The amount of capacity open for bidding would be determined by CEC demand and supply forecasts published in its biennial Electricity Report. The bidding program would have three basic parts:

- Utility development of a proposed plant which would establish the price at which the utility could produce electricity. This proposal would, in effect, establish a ceiling price that other bidders would have to beat.
- Selection of winning bidders using both an auction and evaluation of certain “nonprice” criteria (potentially including such factors as fuels diversity goals, and state employment effects).
- Negotiations between the utility and the winning bidders to develop a final contract.

Changes in the Industry

The existing utility industry structure primarily is the result of past regulatory policies that favor vertically integrated, monopoly utilities. Since the early 1970s, significant changes have occurred at all stages of production, but especially in the electrical generation stage. Our review of the available evidence calls into question the current bases for regulating the electrical generation industry.

**Economies of Scale.** Some recent studies suggest that smaller power plants can be as efficient as larger plants. This means that cost-effective power can in fact be generated by a wide variety of producers. Some of the factors influencing smaller plant size include reduced demand growth, environmental and other regulatory concerns regarding larger plants, financial commitment and construction lead times for larger plants, and technological change.

**Entry.** Experience with PURPA has shown that a nonutility power producer industry can develop. Because this entry largely was the result of lucrative contract opportunities, it is difficult to assess prospects for entry under more competitive conditions. There are signs, however, that entry could occur without the subsidies included in the PURPA contracts. These include the existence of: (1) an industry with proven technology, (2) capital markets that now understand these investments, and (3) entrepreneurs and managers with experience in this business.

**Quality of Service.** Vertically integrated utilities defend their structure by arguing the need to coordinate and protect the reliability of the bulk
transmission system and the local distribution systems. Typically, these arguments are based on technical engineering considerations related to the design and control of the bulk power transmission segment of the industry. Again, however, there is evidence providing support for a generating market that is more competitive and that has less direct ownership of power plants by utilities. These factors include (1) development of computer controls and monitoring technology, (2) improved analytical understanding of bulk transmission system operations, (3) knowledge about the operation of tightly coordinated systems elsewhere in the country and, (4) better understanding of how the use of sales contracts between power producers and utilities could substitute for internal company transactions.

In light of these changes, regulatory agencies both at the federal and state levels are reviewing their regulatory policies for electricity generation. In particular, FERC is considering several proposed rulemakings that together could result in reduced regulation for nonutility power producers. In addition, the PUC is finishing rules to govern the capacity bidding program mentioned earlier and has undertaken other reviews of existing regulatory processes. The potential for a more competitive electricity generation market also is recognized by the CEC in its draft 1988 Electricity Report.

ALTERNATIVE APPROACH TO THE ELECTRICAL GENERATION MARKET

We recommend that the Legislature undertake a thorough review of the state’s regulation of the electric utility industry, and consider ways to make regulatory policy consistent with the more competitive environment.

As discussed earlier, the electric utility industry is regulated as a natural monopoly. But perceptions about the industry among observers and participants are changing, especially with regard to electricity generation. The Legislature and state agencies have also recognized the need to reconsider the state’s regulatory role in this area. Chapter 495, Statutes of 1986 (SB 1970, Rosenthal) required the CEC and PUC to review—among other things—the state’s regulation of the industry. In their report Joint CEC/CPUC Hearings on Excess Electrical Generating Capacity (known as the SB 1970 report), the PUC and CEC recommend that the Legislature establish a blue ribbon panel to review existing energy and electric utility regulatory policies. Legislation has been introduced in the current session (SCR 7, Rosenthal), which calls for a Joint Committee on Energy Regulation and the Environment to review energy regulatory policy.

These calls for review of California’s energy policy development and regulatory processes are consistent with our findings. We therefore
recommend that the Legislature undertake a complete review of utility regulation with the objective of considering ways to make regulatory policy consistent with the increased scope for competition in the utility industry.

If the Legislature undertakes such a review, we believe there are several key areas to consider and resolve. These general policy areas should be considered in relation to the goal of enhancing the prospects for competition. The goal of increased competition would not conflict with the continued need for environmental and safety regulation.

**Move Beyond Bidding to Competition**

As discussed earlier, the PUC has developed bidding rules which offer the opportunity to increase the market share of nonutility power producers. There are potential problems with bidding, however, that could result in continued utility domination of generating capacity and de-facto return to existing regulatory procedures. These problems include: (1) unnecessarily limiting the pool of bidders through stringent prequalification requirements; (2) potential conflicts of interest arising if utilities are allowed to both administer auctions and submit bids; and (3) complex and protracted negotiations if bid evaluators consider “non-price” elements of bids (for example, fuels diversity or employment effects).

These concerns have been expressed by the nonutility producers and other observers, and would appear to have some merit. As a way of addressing these concerns, the Legislature and PUC may want to consider the following approaches.

**Use Bidding Only in the Near Term.** The PUC should use bidding only as the next step on the path toward more open competition in the electricity generation market. Therefore, during the time bidding is used, every effort should be made to keep the pool of bidders as large as possible. This could be accomplished by: (1) eliminating prequalification requirements (the likelihood that electricity shortfalls would result from failure of a bidder to perform are minimal), (2) selecting winners only on the basis of price (there are usually other, more appropriate forums for resolving nonprice issues) and (3) monitoring negotiations and bids to prevent utilities or bidders from engaging in activities that might subvert the intent of the bidding proceedings.

**Move to Market Pricing.** Ultimately, the PUC's bidding process could be phased out and replaced with market pricing of power and contracting by producers directly with utilities and other users (with PUC intervention limited to normal “prudency reviews”). Such a market would include both short-term sales of electricity (the spot market) and a mix of short-, medium- and long-term contracts for other sales of power.
The spot market and access to many buyers (both utilities and large retail customers) with whom contracts could be negotiated would serve to police the market.

**Address the Issue of Utility Generating Capacity**

Due in part to past regulatory activity, utilities currently are the main sources of generating capacity in the state. All current utility investment in power plants are in the "rate base," which means that the utility is virtually guaranteed of receiving an adequate return on investment over the life of the plant (through charges to consumers).

In a competitive generation market, however, the investment risk would be borne by power plant producers, not consumers. In order to move toward a competitive market, there must be a level playing field for all players—utilities and nonutilities. Therefore, the Legislature will have to address the issue of how to handle future utility power plant proposals.

One way to create a level playing field would be to limit the utilities to their current rate base plant capacity (with the possible exception of small specialized plants used to meet peak demand). Over time, both growing electricity demand and the closing of old utility-owned plants would cause the remaining utility-owned capacity to become a comparatively small part of the total electricity required by the utilities to meet customer needs. At this point, utilities would have to rely on the market to obtain electricity at the best available price.

Currently, utilities are allowed to establish unregulated subsidiaries to build generating facilities and sell power to the market (including the "parent" utility company). If this practice continues, consideration should be given to placing some restrictions on subsidiaries, such as: (1) allowing them to negotiate contracts only with utilities other than the parent, or (2) limiting subsidiaries to sales in the spot market. These relatively minor restrictions, combined with diligent antitrust oversight, would significantly increase the prospects for a competitive market in electricity generation.

**Address the "Transmission Access" Problem**

Many observers who advocate deregulation of electricity generation argue that the so-called "transmission access" problem must first be resolved. This problem, in basic terms, is that most of the transmission network is owned and controlled by IOUs and that these utilities don’t want to provide transport services to their competitors. The utilities argue that unlimited access to the system would result in negative effects on small customers and on system reliability.
The access problem ultimately will have to be resolved in order to have a competitive generating industry. It is not clear, however, that transmission access is an immediate problem. For instance, PURPA already requires utilities to provide transmission services for contracted power. In addition, demand is growing at a moderate rate and existing proposals for expansion of the bulk transport system could remove the most significant current capacity constraints. Furthermore, system reliability concerns could be mitigated by having all power producers meet specified bulk transmission system requirements.

Over the long run, however, there will have to be solutions to various transmission problems: (1) lack of utility incentives to sell transmission services to nonutility power producers (who compete with the utility’s generation plants), (2) monopoly power resulting from ownership of “bottleneck” transmission lines and (3) public health and visual impact issues that cause resistance to the construction of new transmission lines.

Of these problems, the lack of utility incentives and monopoly power are the most important in the context of creating a competitive electricity generation market. There are, however, ways to mitigate these problems. For instance, a utility’s incentive to favor its own generation capacity could change if it finds itself going to the spot market (as described above) for substantial amounts of power. Additionally, FERC is considering alternatives to achieve more open access in recent regulatory decisions and proposed rulemakings. If utilities continue to resist access or use bottlenecks to exploit their monopoly power, the Legislature could consider more forceful remedies, including requiring mandatory access, requiring stricter regulation, encouraging construction of competing transmission lines or requiring divestiture of bottleneck transmission lines. While public health and visual impact issues must also be resolved, these issues exist independently of the degree of regulation of the electrical generation market.

**Consider Phasing Out Energy Commission’s Needs Assessments**

The California Energy Commission was established in 1973 and given various energy planning, technology development, building standards development, electricity forecasting and power plant siting responsibilities. The CEC also has a role in the regulation of electricity generation because it is charged with siting most thermal power plants. This siting process includes both an environmental assessment and a “needs” assessment. The environmental assessment determines whether the proposed plant meets the California Environmental Quality Act requirements and the needs assessment determines whether the plant is necessary in order to meet the commission’s forecasted electricity demand. The latter was designed to protect customers from having to pay for unneeded power plants.
A competitive electricity generating market, however, would eliminate the necessity for the CEC's needs assessments process. This is because in a competitive industry the power producers—not consumers—would bear the risk of their investment decisions. As market pricing would provide the signals to investors regarding whether to undertake power plant investments, the CEC would no longer need to become involved in those decisions.

**Change the Purpose of the Energy Commission's Electricity Forecasts**

The CEC is required to publish a biennial *Electricity Report* that includes multi-year forecasts of electricity demand and supply. Currently, these forecasts are used primarily to determine how much electrical generation capacity is needed in designated planning areas, and whether a specific plant proposal should be certified as “needed.” Developing these forecasts is an involved regulatory process that includes written and oral testimony by many interested parties, each with competing economic interests. It is both a labor- and time-intensive process (the CEC has up to 80 personnel working on forecasting and needs assessment activities at various times during the biennial cycle) and usually results in compromises regarding the specific demand and supply forecasts published for each planning area.

If electricity generation were deregulated, the CEC would no longer have to do needs assessments as part of its power plant siting responsibilities, as individual power producers would do their own assessments of need. Thus, the CEC would no longer have to engage in the current regulatory process for developing its forecasts.

Given the commission's continuing role in statewide energy policy formation, some type of electricity forecasting capability would still be desirable. However, the capability needed to support the development of general energy policy would be very different from the needs of the existing complex regulatory process and would require many fewer personnel and other commission resources. Additionally, forecasts that are done independently of other forecasters and which are not the result of a regulatory process or negotiated compromises would be more likely to provide useful information to investors and policymakers.

**Summary**

The electrical generation market has changed considerably in recent years and will continue to evolve in the future. It is important for the state to adapt its regulatory oversight of the electric generation industry to comport with this new environment. The Legislature has several steps which it can consider and act on now in order to move the industry toward a more competitive market in the 1990s.
Implementation of Proposition 98

What Are the Proposition 98 Implementation Issues Facing the Legislature in the Coming Year?

Summary

- The Governor's Budget proposes to fund the Classroom Instructional Improvement and Accountability Act—Proposition 98—at a level of $116 million in 1988-89 and approximately $400 million in 1989-90.
- The implementation of this act and the allocation of funding for its purposes will be subject to legislative determination.
- There are several issues that the Legislature should address in implementing legislation, including: (1) the allocation of funds to education programs; (2) the definition of "enrollment"; (3) the definition of the "excess revenue" cap; and (4) the allocation of excess revenue.
- There are other issues the Legislature may wish to consider, including: (1) How should the General Fund percentage be calculated? (2) What should be included in the General Fund revenue base? (3) How should discretionary ADA be calculated? (4) How should the minimum funding level be determined in a year after the funding requirement has been waived? (5) Should there be sanctions imposed on districts that spend their Proposition 98 funds on unauthorized programs?
- We recommend that the Legislature wait until the May revision of the 1989-90 Budget Bill before appropriating any funds for Proposition 98.

In November 1988, the voters of the state passed Proposition 98, the "Classroom Instructional Improvement and Accountability Act," which significantly changes the manner in which K-12 schools and community colleges will be funded in the future. The discussion which follows outlines the provisions of Proposition 98 and their fiscal effects, and discusses important implementation issues facing the Legislature.

THE PROVISIONS OF PROPOSITION 98 AND THEIR FISCAL EFFECTS

Proposition 98 has three main provisions: K-14 funding, school accountability, and a prudent state reserve.

K-14 Funding

The primary purpose of Proposition 98 is to increase state funding for K-12 schools and the community colleges. It contains two mechanisms to
accomplish this goal: the "minimum funding level" provision and the "distribution of excess revenues" provision.

Minimum Funding Level. Starting in 1988-89, Proposition 98 requires the state to annually provide a minimum level of funding for public schools and community colleges. The measure specifies two methods for determining what the minimum funding level should be and requires the state to use the method that results in the larger amount:

- The first method requires the state to ensure that the percentage of state General Fund revenue that is allocated to public schools and community colleges is not less than the percentage that was allocated to them in 1986-87.
- The second method requires the state to ensure that public schools and community colleges receive from state and local tax revenues the same total amount of funds received from these sources in the prior year, adjusted for changes in inflation and increases in enrollment.

Our analysis indicates that the cost of this initiative in 1988-89 will be determined by the first of these options, as General Fund revenues have grown more rapidly in the last two years than inflation and enrollment increases. The actual cost, however, will depend upon the final level of General Fund revenues and the interpretation of which revenues should be counted in the calculation base.

Our November 1988 ballot analysis of Proposition 98 estimated current-year costs at $215 million. This figure was based on revenue estimates made last July when the budget was adopted. Revenue estimates in the Governor’s Budget, however, are lower than they were last summer. As a result, our estimates of Proposition 98 costs in the current year also have been lowered—to $174 million. This figure will continue to be adjusted as revenue estimates change during the remainder of this fiscal year.

Based on the advice of the Legislative Counsel’s Office, we used a broad interpretation of the revenue base—one that counts all General Fund revenues, including transfers and nontax revenues—when we developed our estimates for this measure. This definition was used because the affected section of Article XIIIIB of the State Constitution refers not only to tax proceeds, which are subject to limitation, but also to other proceeds. We have consistently used this interpretation in all of our fiscal estimates of this measure.

The Department of Finance, however, is using a narrower definition of the Proposition 98 revenue base—one that excludes nontax revenues. The department’s methodology, which is compared to ours in Chart 1, results in a slightly higher percentage of General Fund revenues dedicated to K-14 funding, which is then applied to a significantly lower 1988-89
General Fund revenue base. As a result, the Governor's Budget reflects a cost estimate for the current fiscal year of $116 million, or $58 million less than our estimate of $174 million.

<table>
<thead>
<tr>
<th>SOURCE</th>
<th>1988-87 K-14 Funding</th>
<th>1988-87 General Fund Revenue</th>
<th>Required K-14 Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>LAO</td>
<td>$12,715,087</td>
<td>$32,535,200</td>
<td>39.081%</td>
</tr>
<tr>
<td>DOF</td>
<td>12,703,047</td>
<td>31,673,000</td>
<td>40.107</td>
</tr>
<tr>
<td>Difference</td>
<td>$12,040</td>
<td>$862,200</td>
<td>-1.026%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SOURCE</th>
<th>1988-87 Proposition 99 K-14 Funding Requirement</th>
<th>1988-87 K-14 Funding</th>
<th>Required K-14 Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>LAO</td>
<td>39.081%</td>
<td>$36,001,960</td>
<td>$14,069,926</td>
</tr>
<tr>
<td>DOF</td>
<td>40.107%</td>
<td>34,930,000</td>
<td>14,009,375</td>
</tr>
<tr>
<td>Difference</td>
<td>-1.026%</td>
<td>$1,071,960</td>
<td>$60,551</td>
</tr>
</tbody>
</table>

In 1989-90, we estimate that the cost of the minimum funding level will be about $465 million, as compared with the Governor's Budget estimate of about $400 million. Both estimates assume that the first formula option—maintaining the 1986-87 level of General Fund support—will be used. Again, our difference regarding the calculation of the revenue base (the nontax revenues issue) leads to the difference in the cost estimates.

**Revenues in Excess of Limit.** The initiative also requires that all or part of any General Fund revenues (in an amount equal to 4 percent of the minimum funding level) in excess of the state's appropriations limit be allocated to public schools and community colleges until such time as the state meets or exceeds specified goals in (1) per-pupil expenditures and (2) average class sizes. This allocation of so-called "excess revenues" would be in addition to any state appropriation required to maintain the minimum funding level. The excess revenues also would be added to the minimum funding level and rolled into the base. **As a result, they would become a permanent part of the minimum funding level that would need to be maintained in subsequent years and most likely would have a compounding effect on the share of the state's budget that would be**
dedicated to K-14 education. While the Governor’s Budget shows the state being slightly under its limit in both the current and budget years, small improvements in the revenue forecast would result in excess revenues in either year.

Additional Revenues Benefit K-14 Education. Any such additional state revenues would greatly benefit K-14 education. Specifically, as shown in Chart 2, if additional revenues were to materialize in 1989-90, K-14 education would first receive 40 percent of any amount up to the state’s appropriations limit (a maximum of $51 million based on the Governor’s Budget estimate of $128 million remaining in the state’s appropriations limit). K-14 education would then be entitled to all of any remaining “excess revenues” up to the 4 percent “revenue cap” discussed previously, or approximately $607 million. Thus, in total, K-14 education would receive $658 million (approximately 90 percent) of the first $735 million in additional state revenues. Finally, any additional revenues above the cap level would be rebated to taxpayers.

School Accountability Report Cards

Proposition 98 requires the Superintendent of Public Instruction to appoint and consult with a task force to (1) develop a model School Accountability Report Card and (2) present it by March 1, 1989 to the
State Board of Education for adoption. The measure provides that a majority of the task force members shall be teachers, with the remaining members composed of school administrators, parents, school board members, classified employees, and educational research specialists.

The model report card would contain information on a variety of school conditions, including, but not limited to:
- Student achievement,
- Dropout rates,
- Expenditures per student and services funded,
- Class sizes,
- Assignments of teachers outside their subject areas,
- Textbook quality,
- Student services,
- School safety,
- Teacher evaluation and staff development,
- Classroom discipline, and
- Instructional quality.

The measure requires each public elementary, high school, and unified school district to issue an annual School Accountability Report Card for each of its schools, beginning in 1989-90. The measure provides that, at a minimum, each report card must contain information on the conditions noted above.

We estimate that it will cost school districts from $2 million to $7 million annually, beginning in 1989-90, to prepare and distribute the School Accountability Report Cards required by Proposition 98. This is based on an estimated cost of between $250 and $1,000 per school for each of the approximately 7,000 schools in the state. Actual costs will depend on the amount of information that schools already collect on school conditions.

**The Prudent State Reserve**

Proposition 98 requires that “the Legislature shall establish a prudent state reserve fund in such amount as it shall deem reasonable and necessary.” Because the initiative does not specify the size of the reserve, and since the Legislature already maintains a reserve, this provision will have no direct impact on current practices.

**ISSUES RELATED TO THE IMPLEMENTATION OF PROPOSITION 98**

We have identified two groups of issues that will need to be addressed by the Legislature in implementing Proposition 98. In the first group, we include issues that should be addressed in implementing legislation. In the second group, we include issues which most likely will confront the Legislature and which would be desirable to resolve.
Issues That Should be Addressed by the Legislature

1. Allocation of Funds. The Legislature will need to decide how to spend the additional Proposition 98 funds for both the current and budget years. There are two broad ways in which these funds could be allocated. First, they could be allocated as general purpose revenue, which districts could spend as they see fit. Second, they could be targeted to specific programs.

An unrestricted allocation could be accomplished in several different ways: on the basis of enrollment, through a revenue limit equalization formula, or for a cost-of-living adjustment to general-purpose school apportionments. Each of these funding mechanisms would result in a different distribution of funds among districts. For example, an allocation on the basis of enrollment would result in each district receiving the same amount per pupil. A revenue limit equalization formula, on the other hand, would result in different amounts per pupil, depending on each district’s own revenue limit in relation to the state average. In each case, however, local districts would decide how to use the funds.

Targeted allocations could be used for (1) establishing new programs, (2) expanding existing programs, or (3) subsidizing local costs for existing programs. In the first two cases, the funds would result in an increased level of service through new or expanded programs. Subsidizing local costs for existing programs would be similar to an unrestricted allocation, except that it would guarantee a certain level of state funding for the targeted programs. For example, the state could provide funds to fully support the cost of home-to-school transportation. This would ensure full funding of transportation, while supplanting local funds that are currently used for this purpose. The local funds could then be used for any other purpose determined by the local districts.

1988-89. The Governor’s Budget would spend $116 million in current-year Proposition 98 monies by allocating $77 million to fund estimated current-year K-12 funding deficiencies and $39 million to a K-12 Proposition 98 reserve. The reserve would be disbursed to school districts at the end of the current fiscal year, according to criteria that presumably would be determined by the Legislature and the administration. The Governor’s Budget proposes no Proposition 98 funding for community colleges in the current year.

1989-90. The Governor’s Budget proposes to allocate approximately $400 million for Proposition 98-related expenditures in the budget year as follows:

- $230 million for an education reserve ($220 million for K-12 schools and $10 million for community colleges),
- $110 million for class size reduction in grades 1-3 and 9-12,
• $30 million for year-round school incentive payments,
• $17 million for drug education, and
• $15 million for funding discretionary growth in special education programs.

The budget proposes to use the education reserve first to fund any K-14 education deficiencies that may occur. Any balances that remain after deficiencies have been funded would be disbursed at the end of the fiscal year in accordance with as-yet-undetermined criteria. We note that in the absence of Proposition 98, these funds would have been available for any legislative purpose, including K-14 education.

2. Defining Enrollment. Another issue that needs to be addressed in legislation to implement Proposition 98 is the definition of enrollment. The initiative requires that school district and community college enrollment data be used to compute minimum funding requirements and to allocate any “excess revenues” in the event they are available. Enrollment is defined by the initiative as:

- Average daily attendance (ADA) in K-12 schools,
- ADA equivalents for K-12 services not counted in ADA, and
- Full-time equivalent (FTE) students in community colleges.

The implementing legislation should include formulas for computing ADA equivalents for services not currently counted in ADA, such as summer school programs and enrollment in the state special schools.

In addition, because community college enrollment is currently measured by ADA, legislation to implement Proposition 98 would need to include a formula for converting ADA to FTE students. The conversion to FTE will also be needed to make interstate funding comparisons required by the act, as all other states measure their community college enrollment in terms of FTE.

3. The “Excess Revenue” Cap. A third issue to be addressed is the definition of the excess revenue cap. As noted, the initiative requires that K-12 schools and community colleges be allocated specified excess revenues “up to a maximum of four percent (4%) of the total amount required pursuant to Section 8(b).” Section 8(b) specifies the amount required to achieve the minimum funding level discussed previously. This amount is only provided from state General Fund revenues. Consequently, the determination of any excess funding is only a function of those revenues. We estimate that 4 percent of 1989-90 General Fund expenditures for K-14 education is approximately $607 million.

Others have suggested that the reference in Section 8(b) to “monies to be applied by the state” includes local property revenues, since (pursuant to state law) these revenues are also applied to the support of K-14 education. According to this position, the maximum amount of excess
revenue that must be allocated to K-14 education would be equal to 4 percent of the total of state General Fund plus local property tax support—approximately $803 million in 1989-90. In our view, local property tax revenues are not part of “the monies to be applied by the state” that are addressed in Section 8(b).

4. Identification and Allocation of “Excess Revenue.” Finally, the Legislature will need to address the issue of the identification and allocation of excess revenue. The initiative requires the automatic allocation of excess revenues by the State Controller to schools for specified purposes. It does not, however, indicate when the allocation should take place. To implement this provision, the Legislature will need to determine when it can be known how much (if any) excess revenue is available. To accomplish this, it should consider establishing a procedure and timetable that would govern (1) the certification of the availability of excess revenues by the Director of Finance to the Controller and (2) the allocation of excess revenues by the Controller. This same procedure should contain a mechanism for the Director of Finance, the Superintendent of Public Instruction, and the Chancellor of the California Community Colleges to certify to the Controller if and when the allocation of excess revenues is no longer required because the goals for per-pupil expenditures and class sizes have been met.

Issues that May Confront the Legislature

1. Calculation of the General Fund Percentage. One of the two guaranteed minimum funding levels established by Proposition 98 for K-14 education is based on the percentage of General Fund revenue that was provided for this purpose in 1986-87. Specifically, Section 8(b) (1) of the initiative refers to:

The amount which, as a percentage of the State General Fund revenues which may be appropriated pursuant to Article XIIIB, equals the percentage of such state General Fund revenues appropriated for school districts and community college districts, respectively, in fiscal year 1986-87.

Because of this section’s reference to “the percentage” (singular), we have based our cost estimate on the calculation of a single percentage encompassing both school district and community college funding.

The State Department of Education (SDE), however, has prepared a cost estimate which uses separate percentages for school districts and community colleges. This interpretation could imply a substantial difference in the required allocation of the K-14 funds. Specifically, the SDE’s approach might require that all of the current-year Proposition 98 funds be allocated to K-12 education, with none allocated to community colleges. This is because, when calculated separately, the percentage of General Fund revenue that has been appropriated to community col-
leges in the current year is already greater than the percentage that they received in 1986-87. Under the single percentage methodology, the Legislature would have discretion in determining the allocation of funds between K-12 schools and community colleges.

2. Defining the General Fund Revenue Base. As discussed earlier, another difference of interpretation involves the question of whether General Fund revenues which may be appropriated pursuant to Article XIIIIB include those revenues which are not considered to be “proceeds of taxes.” According to the proponents of this view, because only revenues which are tax proceeds must be appropriated subject to the appropriations limit, only tax proceeds are appropriated pursuant to Article XIIIIB.

The Legislative Counsel, however, has issued an opinion which concludes that all state revenues are “revenues received” as that term is used in Section 2 of Article XIIIIB (the section which requires the return of excess revenues), and concludes that nontax state revenues “may be appropriated in compliance with Article XIIIIB without limitation.” On this basis, Counsel advises that nontax revenues should be included in the General Fund revenue base, and our estimate reflects this position. The Legislature may wish to clarify this point in statute by providing a definition of the General Fund revenue base.

3. Discretionary ADA. In elementary and secondary schools, enrollment increases or decreases are a natural consequence of changes in the school-aged population. However, enrollment increases in community colleges and in some programs operated by K-12 school districts are discretionary. In other words, annual changes in enrollment are subject to state and/or local policy decisions. For example, the state controls enrollment growth in community colleges so that it does not exceed the percentage increase in California’s adult population. Similarly, enrollment increases in some school district programs, such as supplemental summer school or Regional Occupational Programs, are controlled by the state.

The average daily attendance (ADA) funding mechanism in Proposition 98 contains a fiscal incentive for the state to limit discretionary ADA growth in these controllable programs. This is because, in future years, Proposition 98 will require the maintenance of total funding per ADA—an amount that is generally much greater than the actual average cost per ADA (or ADA-equivalent) of these discretionary programs. For example, the supplemental summer school program is currently funded at the rate of $1,274 per ADA-equivalent. Each new unit of summer school ADA under Proposition 98, however, will generate a funding requirement of about $3,400 per ADA—the average rate of total state and local funding per ADA. In other words, Proposition 98 requires that
funding per ADA for some programs exceed the cost and current funding rate per ADA of those programs. This situation could generate an incentive to limit or eliminate discretionary ADA growth in these less-costly programs.

If the Legislature wishes to address this situation, it could redefine the overall Proposition 98 ADA base by measuring the broadest possible range of instructional services in terms of ADA-equivalents, such that the cost per ADA-equivalent is roughly the same for all programs.

An alternative method for avoiding the incentive to limit growth in discretionary programs would be to eliminate the ADA in such programs from the calculation of the minimum funding requirement. Although the initiative requires that all ADA be used, it also gives the Legislature the authority to change its provisions in order to “further its purposes.” Arguably, changing the definition of ADA that must be used in calculating the minimum funding requirement could be seen as furthering the intent of the initiative if it eliminated undesirable consequences while having little or no fiscal impact.

4. Determining the Minimum Funding Level in a Year After the Requirement Has Been Waived. The initiative allows the Legislature to waive the minimum funding level requirement with urgency legislation (other than the Budget Act). It does not indicate, however, how the required funding level should be computed in a year following the year in which such a waiver has been enacted. Specifically, the question is whether the funding level should be computed on the basis of the prior year’s actual funding level or on what the prior year’s funding level would have been if the requirement had not been waived. The latter course would provide greater revenue to K-14 education, with a correspondingly greater cost to the state.

5. Sanctions. While the initiative requires that excess revenues be spent for specified purposes, it does not impose any sanctions on districts that spend them on unauthorized programs. The Legislature may wish to impose such sanctions.

CONCLUSION

The Governor’s Budget contains $116 million in the current fiscal year and approximately $400 million in 1989-90 in new K-14 funding related to the adoption of Proposition 98. The expenditure of these funds will be determined by legislatively approved appropriations (see Item 6110-198-001 in the Analysis for a detailed discussion of expenditure options).

We caution that there are several reasons why the Legislature should not rush to appropriate these funds. First, given the funding formula approved by the voters, the current-year and budget-year Proposition 98 cost estimates will continue to change as the year progresses. Specifically,
a General Fund revenue change affects the measure's cost because of the requirement to provide a specified percentage of General Fund revenue for K-14 education. For example, a $100 million increase or decrease in General Fund revenue would result in a $39 million increase or decrease in the initiative's cost.

Second, before allocating any 1988-89 Proposition 98 monies, the Legislature should first address funding of current-year K-14 deficiencies. To do otherwise could result in the state providing districts with funds in excess of the Proposition 98 funding requirement.

Because of the possibility of unforeseen changes in both General Fund revenue and K-14 deficiency requirements, we recommend that the Legislature wait until the May revision of the 1989-90 Budget Bill before appropriating any funds for Proposition 98. This would allow a response to the initiative based on the most current information regarding current-year revenues and K-14 funding requirements. It would also give the Legislature time to consider the implementation issues which we have raised above.
State Accounting Practices

Do the Accounting Changes Reflected in the Governor's Budget Help to Improve the Accuracy of California's Financial Statements?

Summary

- The Governor's Budget reflects two changes in the way the state's General Fund condition normally has been reported by the Department of Finance. These changes have the effect of increasing the amount of funds that the department reports as uncommitted and available for appropriation in 1987-88, 1988-89 and 1989-90.
- On this basis, the budget indicates that the state did not end 1987-88 in a deficit position, as has been reported by the State Controller.
- The changes raise the question of whether they contribute to a more accurate presentation of the state's financial condition. Our review of these changes indicates that they do not, because they lead to an overstatement of the amount of funds which are uncommitted and available for appropriation.
- For this reason, the adoption of these changes by the department raises concerns about potential confusion among users of the state's financial data, given that the department's figures will differ from the State Controller's reports and those of the Auditor General. The Legislature may wish to consider whether a specific procedure for the implementation of changes to the state's accounting system is warranted.

The 1989-90 Governor's Budget reflects two changes in the state's traditional method of accounting for state General Fund expenditures and obligations. These changes have the effect of increasing the amount of money that is considered to be "left over" after the state's obligations are accounted for, and therefore increase the amount considered to be available for appropriation by the Legislature. As a result of these changes, the administration reports that the state did not end 1987-88 in deficit, as reported by the State Controller. According to the administration's figures, the state actually had almost $4 million left in the Special Fund for Economic Uncertainties (SFEU) on June 30, 1988. The accounting changes reflected in the budget also affect the state's reported financial condition for 1988-89 and 1989-90.

This section examines the administration's accounting changes and their consistency with the state's policy of "moving towards" conformity with "Generally Accepted Accounting Principles" (GAAP). We also discuss the method by which the administration will implement these changes and the effect they will have on the state's official financial statements. Finally, we present some concerns relating to these changes.
What Changes Are Reflected in the Budget?

The traditional method of reporting the General Fund’s financial condition is referred to as the “Legal/Budgetary Basis” of accounting, and reflects both statutory requirements and traditional practices. The Governor’s Budget reflects the following two changes in the traditional method:

- **It treats goods and services ordered but not received as a reserve rather than an expenditure**, so that they are counted as money “left over” at year end rather than money which has already been expended. Under existing accounting practices, these transactions are treated as an obligation of the state when entered into and recorded as an expenditure charged against the year in which the goods and services are ordered. The administration instead has subtracted these amounts from its General Fund expenditure total, and set up a “reserve for liquidation of encumbrances” to reflect the state’s liability for these payments. This change is represented by the administration as necessary to continue the implementation of 1984 legislation requiring the conformance of the state’s accounting system to GAAP (Ch 1286/84—AB 3372, Stirling).

- **It eliminates the reserve for outstanding but unspent appropriations**, so that they are not considered in determining how much money is available for new commitments. Traditionally, the budget has shown how much of the funds left over at year’s end already has been committed by the Legislature for various purposes. This practice ensures that these existing commitments are taken account of in determining what level of uncommitted resources is available for allocation through the budget process. The budget contains no discussion of the rationale for this change.

Are the Changes Consistent With GAAP?

Chapter 1286 declares the Legislature’s intent that the state’s accounting systems be amended to conform to “Generally Accepted Accounting Principles” (GAAP). This legislation did not establish a specific time frame or set out the order in which actions necessary to bring the state into conformance would occur. It did, however, anticipate that the state’s accounting and budgeting systems would eventually be brought into conformity through the gradual adoption of changes by the Department of Finance (DOF) and the State Controller’s Office (SCO). A task force consisting of representatives of DOF, SCO, and the state Auditor General’s Office has the responsibility for developing recommended changes in accounting policy to the administration. This group, whose
current focus is on developing a system of accounting for fixed assets, did not play a role in the administration’s decision to adopt the accounting changes reflected in the budget.

**What Is GAAP?** GAAP is a set of uniform minimum standards for financial accounting and reporting. The application of these standards to governmental entities is governed by regulations issued by the Governmental Accounting Standards Board (GASB). The adoption of these standards is premised on the idea that fair, accurate and consistent disclosure of an entity’s financial condition will improve its financial management, and allow interested parties to make informed judgments about the entity's ability to carry out its financial responsibilities. Where the accounting standards for private entities focus on net earnings, the focus of the governmental standards is on amounts available for appropriation.

In general terms, the GAAP standards require that all assets and liabilities be fairly disclosed in governmental financial statements. One of the themes embodied in these standards is that revenues should be recorded when they are "earned," and expenditures should be recorded in the year in which the goods and services they purchase are actually "consumed." Another theme is that the financial statements should disclose all obligations which have not otherwise been recorded by establishing a reserve or designation of funds in the amount necessary to satisfy these obligations when they ultimately come due.

The state is currently required by federal law, as a condition of receiving federal grants-in-aid, to prepare a GAAP-based statement of financial condition covering all state funds. This statement is prepared by the Auditor General, in conjunction with the SCO, by "adjusting" the SCO's "Legal/Budgetary Basis" financial statements for the major differences in accounting treatments.

**First Change Is Consistent With GAAP.** The administration is correct in its assertion that the change in the treatment of goods and services which have been ordered but not received is consistent with the GAAP standards. In preparing the annual GAAP-based financial statement, the Auditor General reduces General Fund expenditures by the amount which has been "encumbered" for goods and services not yet received and indicates that a portion of the fund balance will be needed to satisfy these commitments. Thus, if done correctly, this change would have no impact on the amount of funds left over and available for appropriation, but would lead to a more accurate reflection of expenditure levels for the 1987-88 fiscal year. The Auditor General’s Office advises that this adjustment will amount to $241 million for the General Fund in 1987-88, or $10 million less than reflected in the budget.
While the change reflected in the budget is theoretically consistent with GAAP standards, it has not been consistently applied. Specifically, the budget has not extended this treatment to funds other than the General Fund, nor is the reserve established to liquidate these encumbrances adequate to fund the full amount of the encumbrances. The administration reduced the amount of this reserve by $80 million to reflect its plan for the cancellation of outstanding encumbrances. Our review of the amounts outstanding indicates that it will not be possible to save the full $80 million, as most of the encumbrances in question have already been liquidated.

Further evidence of the budget's inconsistent application of the GAAP "consumption" standard can be found in the administration's proposed treatment of 1989-90 Medi-Cal expenditures. Under existing state law, the Medi-Cal program must be accounted for on a "cash basis." This means that expenditures are recorded whenever checks are issued for services rendered, as opposed to when the services are actually "consumed." This has the effect of artificially reducing the level of state expenditures. The budget actually proposes to make the accounting for this program even less reflective of its current activity. Specifically, the administration intends to delay the date when the last batch of 1989-90 checks are written, from June until July, so that these expenditures will not be recorded until 1990-91.

**Second Change Inconsistent.** The second change reflected in the budget is not consistent with GAAP standards. GAAP requires that appropriations which are outstanding at year end but which have not yet been expended be shown as a "reservation" of the ending fund balance. In other words, GAAP requires that, in presenting the amount of funds left over at year end, the statements should indicate how much of these leftover funds have already been appropriated for expenditure. The administration's figures indicate that almost $4 million was left over in the SFEU on June 30, 1988, whereas in fact the state was approximately $200 million short of the amount needed to fund the outstanding appropriations and obligations.

**What Impact Do the Changes Have on the General Fund Condition?**

As noted earlier, the administration's accounting changes have the impact of increasing the amount of funds which is reported to be available for appropriation. Table 1 shows how the accounting changes affect the reported General Fund condition for the prior, current and budget years.
Table 1
Impact of Accounting Changes on
Reported General Fund Condition
1987-88 through 1989-90
(dollars in millions)

<table>
<thead>
<tr>
<th></th>
<th>1987-88</th>
<th>1988-89</th>
<th>1989-90</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncommitted funds per Governor's Budget</td>
<td>$4</td>
<td>$3</td>
<td>$870</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount needed to fully fund 1987-88 encumbrances</td>
<td>$-80</td>
<td>$-80</td>
<td>$-80</td>
</tr>
<tr>
<td>Amount needed to fund outstanding appropriations</td>
<td>$-117</td>
<td>$-43</td>
<td>$-30</td>
</tr>
<tr>
<td>Other SCO corrections</td>
<td>$-7</td>
<td>$-6</td>
<td>$-6</td>
</tr>
<tr>
<td>Amount needed/available to fund commitments</td>
<td>$-200</td>
<td>$-126</td>
<td>$754</td>
</tr>
</tbody>
</table>

a Source: Legislative Analyst's Office estimates based on Governor's Budget.
b Reflects SCO adjustments to reconciliation items shown in Schedule 7 of the Governor's Budget.

As shown in Table 1, the state's General Fund condition would be less favorable without the accounting changes reflected in the Governor's Budget. Specifically, it shows that the General Fund had more commitments outstanding than it had funds available to pay them in the current and prior years. The table also shows that there is less money available for allocation to the SFEU in 1989-90. Even if the administration were to actually "save" a large portion of the $80 million it expects from the cancellation of 1987-88 encumbrances, this would not be sufficient to fund the remaining outstanding commitments shown in Table 1.

What Concerns Do the Changes Raise?

Our review of the accounting changes proposed in the budget indicates that they raise several issues for the Legislature to consider.

Whose Numbers Are Right? In adopting the changes described above, the administration has offered an alternative view of the state's financial condition to that reported by the State Controller. Given that there is also the GAAP-basis statement prepared by the Auditor General to meet federal requirements, this means that the state now has three different official reports as to the state's financial condition.

Although state law provides that the Department of Finance shall design and maintain the state's accounting system, and that the Controller's accounts shall conform to the administration's system, the law does not give the administration the authority to revise the system on a retroactive basis. In fact, the administration advises that it does not intend to make any changes in the accounting system. Rather, the Department of Finance will annually "estimate" the amount of the change for purposes of the Governor's Budget, and the agencies will still report as expenditures their obligations to pay for goods and services not yet received. Thus, there will be no change in the information reported to
the State Controller, and the Controller will still show these encumbrances as expenditures for purposes of the “Legal/Budgetary Basis” financial statements.

In our view, there should be a one-to-one correspondence between the system used by the Legislature and the executive branch for budgeting and planning purposes and the system used by the Controller to report the actual performance of state agencies in carrying out the expenditure plan contained in the budget. To do otherwise leads to confusion among users of the state’s financial data.

How Should Changes to the System Be Made? The changes made in the budget were not announced in advance, and the department does not intend to revise the state’s accounting systems to effect the change. Rather, it will be accomplished through an annual “ad hoc” adjustment to the statewide General Fund expenditure totals.

Further, the changes do not enhance the state’s long-term efforts to bring about full conformity with GAAP standards. This is because to the extent that the administration continues to adopt GAAP-related changes which improve the reported fund balance, it will subsequently be more difficult to adopt those remaining changes which will adversely affect the fund balance, such as the accrual of liability for services rendered under the Medi-Cal program.

The Legislature may wish to consider whether a specific procedure for the adoption of changes in the state’s accounting practices is warranted. Such a procedure could provide for a more considered and consistent application of accounting system changes. Given the state’s policy of moving towards greater conformity with the GAAP standards, it would appear to be appropriate for the Legislature to require that the administration justify proposed changes on this basis prior to their implementation. The Legislature may also wish to solicit input on these changes from the State Controller, the Auditor General, and other interested parties.

Will These Changes Promote Investor Confidence? As noted earlier, one of the objectives of financial reporting is to provide fair and accurate disclosure of the state’s financial condition. As noted above, the administration has chosen to implement these changes in an inconsistent and unsystematic fashion. For this reason, we are concerned that observers may not obtain the most realistic view of the state’s financial condition.

Conclusion

The goal of any accounting system should be to give the Legislature and the executive branch the most realistic assessment of the amount of funds received and expended, and the amount that remains available for appropriation by the Legislature. Recent changes incorporated into the
Governor's Budget do not enhance the accuracy of the reported financial information. Thus, they increase the state's risk of overcommitting its available resources, and highlight the need for the Legislature to consider how changes to the state's accounting system should be made in the future.
Retiree COLAs

How Can the Legislature Best Provide Cost-of-Living Adjustments for PERS And STRS Retirees?

Summary

- Every year the Legislature faces pressure to improve COLAs for members of the State Teachers' Retirement System (STRS) and the Public Employees' Retirement System (PERS).

- The current systems for providing COLAs have the following shortcomings: (1) neither the providers nor the recipients know what level of benefits will be paid each year; (2) benefits are not being paid for as they accrue; (3) the costs are not paid for by the employers and employees (in the case of STRS); (4) the costs of the COLAs are not readily apparent (in the case of PERS); and (5) the COLA mechanism could distort administrative decision making (in the case of PERS).

- Our review indicates that a better COLA mechanism would have the following characteristics: (1) the amount of income maintenance would be certain and known in advance; (2) the funding mechanism would be straightforward and easily understood; (3) COLAs would be prefunded by contributions; and (4) the costs would be paid by employers and employees.

- In order to improve the current COLA mechanisms, we recommend that the Legislature incorporate enhanced inflation protection within the systems' basic benefit structures. For STRS, this could be accomplished through the development of alternative benefit packages from which school districts and teachers could choose.

Virtually every year, the Legislature faces numerous requests to improve cost-of-living adjustments (COLAs) for retired members of the two largest state retirement systems, the Public Employees' Retirement System (PERS) and the State Teachers' Retirement System (STRS). In response to these requests, the Legislature has established several programs—cumulatively costing hundreds of millions of dollars annually—which enhance the basic COLAs provided by both systems as a part of their overall benefit structures. While these enhancements have improved the purchasing power of retirees, they have not addressed—and in some regards, actually worsened—the basic problems with the state's approach to providing COLAs.

In this analysis, we describe PERS' and STRS' current methods of providing retiree COLAs and the problems with them. We then offer
criteria for designing more desirable COLA provisions and offer specific recommendations on how to implement such mechanisms.

Background

The PERS and STRS provide guaranteed monthly retirement payments to thousands of former state workers and teachers. If these payments were not adjusted annually, however, inflation would reduce the real purchasing power of the benefits. Prior to the late 1960s, purchasing power erosion was not a significant concern, as inflation was very low. Since that time, high periods of inflation have greatly affected the buying power of the benefits paid by the system.

In response, the Legislature has enacted three general categories of COLAs for PERS and STRS members:

- **"Basic" COLAs.** Basic COLAs provide annual increases (of up to a certain percentage) to a retiree's monthly allowance to help counteract the impact of inflation. These basic COLAs are guaranteed to members, and as such, are an integral part of the benefit structure. The cost of the COLA is calculated into the basic contribution rate paid by employers and employees, and prefunded over the working lives of the employees.

- **Ad Hoc COLAs.** Ad hoc COLAs are one-time adjustments to the retirement allowances of certain groups of retirees (for example, those retiring before 1971) whose benefits have been especially affected by inflation. Once granted, they become part of the base allowance, restoring value lost due to past inflation. They do not, however, address the need for additional COLA protection against future inflation.

- **Supplemental COLAs.** Supplemental COLAs are nonguaranteed, year-to-year increases in benefit allowances. They are provided contingent on the availability of funding (for example, from a legislative appropriation of funds), and do not increase the "base" allowance. They provide increases over and above the basic and ad hoc COLAs to those retirees whose total benefit payments (including COLAs) fall below a specified percentage of original purchasing power.

The Legislature has used all three types of COLAs to maintain retiree purchasing power. In the following sections, we examine the COLAs provided by each system and discuss the problems associated with each.

**COLAS PROVIDED TO STRS RETIREEES**

The Legislature granted STRS retirees two ad hoc COLAs, one in 1967 and the other in 1972, before adding a basic 2 percent (uncompounded) annual adjustment to all retiree benefits in 1972. In response to the
impact of higher inflation after that time, the Legislature provided three additional ad hoc increases in 1976, 1978 and 1980 to assist certain groups of longtime retirees.

Then, in 1983 the Legislature authorized a supplemental COLA, funded by a discretionary annual budget appropriation. The stated intent of this COLA is to increase the purchasing power of all retiree benefits to 75 percent, with appropriated funds going first to assist retirees who have been most affected by inflation. The Legislature, however, is not required to provide that amount, and in practice has never provided more than 68.2 percent to retired teachers.

Chart 1 shows the magnitude of STRS COLAs provided from the basic 2 percent COLA and the supplemental budget appropriations since 1983-84. It illustrates two main points. First, by far the greatest portion of inflation protection has been provided through annual budget appropriations for the supplemental COLA. In 1988-89, the budget will provide $132.6 million, compared with only $19 million from the basic COLA. Second, the chart shows that the amount provided through the supplemental COLA has grown dramatically since its inception in 1983-84, increasing almost 600 percent during that period. The chart does not include data on ad hoc COLAs (as the numbers are not available from STRS) or on an additional supplemental COLA established in 1983 which

![Chart 1: State Teachers' Retirement System Cost-of-Living Adjustments 1983-84 through 1989-90 (dollars in millions)]
provides a relatively small amount of funds each year. At present, the funds provided through all of the system's COLAs provide purchasing power protection of at least 68 percent for all retirees.

**Problems With Current System**

Our review of the existing method of providing inflation protection to STRS retirees indicates the following problems:

*Supplemental COLA Payments Are Uncertain From Year to Year.* The Legislature annually determines whether and to what extent it funds supplemental COLAs. Because this COLA is paid from the General Fund, it must compete with other legislative programs and priorities. Moreover, the Legislature’s ability to fund these COLAs can vary from year to year, depending on such factors as the General Fund revenue condition or the state’s position relative to its appropriations limit. Consequently, the Legislature cannot know in advance how much money will be available for COLA payments, and retired teachers cannot know what level of purchasing power they will receive.

*Benefits Are Not Being Paid As They Accrue.* Through the annual budget appropriation for the supplemental COLA, the Legislature is, in effect, providing benefits associated with services rendered in past years. Consequently, the costs of the COLA are not being paid as they accrue. This failure to link benefits and costs: (1) shifts costs forward to future generations of workers, and (2) results in higher payments in the future (due to the foregone interest on contributions).

*Those Most Directly Affected — School Districts and School Teachers — Have No Responsibility For, Nor Any Choice In, the COLAs Provided.* Each year, the state makes the decision as to the level of the supplemental COLAs and pays the costs for this inflation protection. Thus, the parties directly involved in this important employee compensation issue—the school districts and teachers—have no direct responsibility for, nor any choice in, the COLAs ultimately provided.

**COLAS PROVIDED TO PERS RETIREES**

PERS added a basic 2 percent COLA to its retirement benefit in 1968. In response to the high inflation of the late 1960s and the 1970s, the Legislature granted numerous ad hoc COLAs between 1974 and 1979 in an effort to maintain the value of retiree benefits.

In 1982 the Legislature first established a supplemental COLA program, with payments contingent upon the availability of funds in a special account — the Investment Dividend Disbursement Account (IDDA). Under IDDA, PERS provides retirees with the greater of either a 10 percent annual increase or an increase sufficient to provide them with up to 75 percent of original purchasing power. In 1988, Chapter 1356 (SB 275,
Russell) increased the maximum possible IDDA benefit to allow up to 80 percent of original purchasing power protection.

Chart 2 shows the magnitudes of the basic and supplemental COLAs provided since 1986-87, with projections through 1990-91. It indicates that in the current year, retirees will receive increases of $188 million from the basic 2 percent COLA and $152 million from the supplemental IDDA COLA. (Numbers were not available for the ad hoc COLAs, but they provide a much smaller level of benefits.)

As Chart 2 shows, PERS provides a significant portion of inflation protection through the supplemental “IDDA” benefits. This COLA works through a complex series of accounts and fund transfers, which are summarized graphically in Chart 3 and briefly described below.
Chart 3
Cashflows To Provide IDDA Benefits

PERF

- Employer Accounts
- Employee Accounts
- Retired Member Reserves

"Excess Earnings" Overflow

Overflow of monies into funds
Payments out of funds

RE Reserve for DEFLICIENCIES

• Reserve assets in excess of 0.3 percent of PERF assets

INVESTMENT DIVIDEND DISBURSEMENT ACCOUNT (IDDA)

Payments for:
- Interest guarantee
- Investment losses
- Court-mandated costs
- Actuarial losses

Payments for Cost-of-Living Benefits

Reversions to Retired Member Reserves

Extraordinary Performance Dividend Account

Payments for Cost-of-Living Benefits

a Up to 75 percent of original purchasing power.
b Up to 80 percent of original purchasing power.
How the IDDA Works. Assets within the Public Employees’ Retirement Fund (PERF) are divided into three accounts: (1) employer accounts, which contain all employer contributions along with all interest earned on these contributions; (2) employee accounts, consisting of all employee contributions and their interest earnings (currently credited at an annual rate of 8.5 percent); and (3) retired member reserves, also credited at an 8.5 percent annual rate.

Any earnings on employee accounts and retired member reserves above the 8.5 percent crediting rate are deposited in the Reserve for Deficiencies — up to a maximum of 0.3 percent of total system assets (approximately $194 million in 1988-89). Funds above this maximum flow out of the reserve and into the IDDA, which is used to pay annual COLAs to retirees (to the extent that the funds are available).

The amount which may be retained in IDDA is limited to the total of the previous four years’ worth of IDDA benefit payments. Funds in excess of this total (up to an amount equal to the previous year’s IDDA benefit payments) then revert to retired member reserves. Any remaining funds flow into the Extraordinary Performance Dividend Account (EPDA), and are used to further supplement retiree incomes up to 80 percent of their original purchasing power.

Problems With PERS’ Current System

Our analysis indicates that the PERS COLA structure has the following problems.

The System is Designed in Such a Way That the Costs Are Not Apparent to Those Paying Them. Because the IDDA system is so complex, the costs of these COLAs are not obvious to either the employers or the employees. A more straightforward mechanism would fund COLAs directly, thereby facilitating legislative decision-making on retirement and compensation issues.

Benefits Are Not Being Paid As They Accrue. As with the STRS COLA mechanism, IDDA provides benefits associated with prior years’ services. Excess earnings on the accounts of current employees are used to pay increased benefits to those already retired. As described above, the failure to pay the cost of benefits as they accrue shifts costs to future generations.

The Source of Funds (“Excess Earnings”) is Unstable Over Time. The basic source of funding for IDDA benefits is the amount of “excess earnings” from the retirement fund. In order to continue paying these COLAs, the retirement fund must continue to earn a rate of return greater than the 8.5 percent actuarial crediting rate. By definition, however, the actuarial rate is an average return over the long run,
meaning that returns of less than 8.5 percent would be expected about half the time.

In the years since IDDA was implemented, the PERS retirement fund has experienced an annual rate of return in excess of the actuarial crediting rate by approximately 3 percent per year. As Table 1 shows, earnings since 1985-86 have received a significant boost from capital gains. Capital gains have increased significantly in the past two years but PERS' consultant does not expect them to continue at the current high levels.

Table 1
PERS Investment Earnings
1982-83 through 1987-88

<table>
<thead>
<tr>
<th>Year</th>
<th>Interest and Dividends</th>
<th>Realized Capital Gains</th>
<th>Total Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982-83</td>
<td>9.93%</td>
<td>1.39%</td>
<td>11.32%</td>
</tr>
<tr>
<td>1983-84</td>
<td>9.94</td>
<td>1.45</td>
<td>11.39</td>
</tr>
<tr>
<td>1984-85</td>
<td>10.13</td>
<td>0.81</td>
<td>10.93</td>
</tr>
<tr>
<td>1985-86</td>
<td>9.63</td>
<td>2.35</td>
<td>11.98</td>
</tr>
<tr>
<td>1986-87</td>
<td>8.81</td>
<td>3.13</td>
<td>11.94</td>
</tr>
<tr>
<td>1987-88</td>
<td>7.97</td>
<td>3.82</td>
<td>11.79</td>
</tr>
</tbody>
</table>

Furthermore, earnings from interest and dividends have been falling in recent years, and they could continue at or below their current rate over the next decade. Therefore, once South African divestment is complete and realized capital gains fall, the fund could well return less than the 8.5 percent crediting rate. If that happens, IDDA benefit payments would begin to draw from the accumulated reserves within the IDDA account. If the rate of return remains below 8.5 percent long enough for IDDA payments to deplete the reserves, the board will have to discontinue making COLA payments.

As with STRS, then, there is no certainty that monies will be available to fund IDDA benefits in the future, at least at the 75 percent level to which current retirees have become accustomed. Thus, while IDDA was created with the intent to provide a specified level of purchasing power, neither the Legislature nor the retiree can plan with certainty on this level of benefit payments.

The IDDA Funding Mechanism Could Distort Administrative Decision-Making. Although IDDA benefits are only available to the extent that excess earnings exist in the IDDA fund, the amounts in those accounts are in fact actually determined by certain key decisions made by the PERS Retirement Board. Because board decisions affect the amount of funds in the accounts, the IDDA funding mechanism could distort administrative decision-making.
One of the board’s decisions that affects the amount of funds in IDDA is the actuarial crediting rate. The actuarial crediting rate is an important determinant of the magnitude of funds that flow into the Reserve For Deficiencies (and from there into the IDDA). Set by the PERS Board of Administration, the actuarial crediting rate is one of the many assumptions necessary to calculate employers’ annual contributions. This rate is based on actuarial studies and is supposed to reflect the long-run, average rate of return on assets. If the system should lack sufficient funds in IDDA to pay for annual COLAs, however, reducing the long-term crediting rate would produce additional funds flowing to the account.

The actuarial crediting rate is only one example of a variable which could be used to affect the amount of funds in IDDA. Although there is no evidence that the board has made such decisions, a more straightforward COLA mechanism would be independent of such administrative decisions.

**HOW CAN THE LEGISLATURE BETTER PROVIDE RETIREE COLAS**

Given these problems, the Legislature may wish to consider how it can more effectively provide improved purchasing power for its retirees. Our analysis indicates that a COLA mechanism for retirees should have the following characteristics:

- **The Amount of Income Maintenance Should Be Certain and Known in Advance.** In order to help retirees and employers plan for their financial futures, it is important that COLAs are known in advance. Neither the STRS nor PERS COLAs meet this criterion.

- **The Funding Mechanisms Should Be Straightforward.** A COLA mechanism should be designed so that the costs are apparent to those paying for them. As described above, the PERS COLA is so complex that it is unclear to many who bears the costs of financing the benefits.

- **COLAs Should Be Prefunded.** All retirement benefits except for supplemental and ad hoc COLAs are funded by employer and employee contributions so that the full expected cost is paid for by the time the employee retires. This approach is called prefunding, and it ensures that retiree benefits are paid for over the working lives of those retirees. If COLAs are viewed as part of the basic retirement package, they should be prefunded in the same way. In other words, they should be paid over the employee’s working life through employer and employee contributions. The amount of contributions necessary to finance such benefits can be estimated using actuarial cost assumptions in the same way such contributions are set for other retirement benefits. In contrast, the STRS and PERS supplemental COLAs are—by definition—“pay-as-you-go” benefits.
• **COLAs Should Be Paid For By the Employer and the Employee.** As part of the retirement benefit that provides income to employees when they retire, COLAs are a valuable part of the employee's compensation package (along with salary, health benefits, and other benefits). Consequently, sound fiscal policy would indicate that the costs of these benefits should be borne by the employer and employee. Currently, the cost of the STRS supplemental COLA is borne by the state.

**Recommendations for Improving the Current COLA Mechanism**

The Legislature has stated its intent that PERS and STRS retirees should have their purchasing power protected. The level at which to provide inflation protection is a basic policy decision for the Legislature, and depends on such factors as: costs, the adequacy of the basic retirement allowance, whether retirees have social security and/or health care coverage, and the financial needs of a retiree over time. If, however, the Legislature decides that it wants to provide a certain level of enhanced protection, we recommend that it provide those benefits in the same way it provides all other retirement benefits: they should be an integral part of the basic benefit plan (like the basic 2 percent COLAs). Such a COLA would have all of the desirable characteristics discussed above:

- The benefit would be guaranteed and known in advance;
- The costs, which would be reflected in contribution rates, would be apparent to all;
- Costs would be prefunded, assuring that liabilities were paid over the member’s working life; and
- The benefit would be paid for by the employer and employee. Accordingly, we make the following recommendations specific to each system.

**STRS**

*We recommend that the Legislature enact optional STRS benefit packages which include enhanced purchasing power protection.*

Technically, it would be relatively easy for STRS to provide enhanced inflation protection within its basic benefit structure. The problem is that the state would be fiscally liable for the entire costs of these benefits, due to constitutional mandate provisions. In order to relieve the state of a cost which properly should reside at the local level (that is, with school districts and teachers), we recommend that the Legislature provide optional alternatives to the existing benefit package which would provide enhanced purchasing power protection. These alternative packages could take many forms, including: (1) the current STRS benefit structure,
enhanced by different COLA "add-ons," or (2) modified benefit structures that would reduce other benefits in order to provide enhanced COLAs at little or no added cost.

If local districts opted to elect these alternatives, they would pay the costs of the enhanced benefits. These costs could be paid at the district expense, by teachers, or through a negotiated sharing arrangement between the two. The cost of providing improved inflation protection, would depend upon the COLA selected. For example, a district electing to provide a 3.5 percent COLA (compounded) would pay an additional 3.36 percent of its payroll (approximately). Similarly, the cost of providing 75 percent protection would be about 5.5 percent of payroll.

What About Current Retirees? Even if the Legislature were able to shift to the local level the costs of providing enhanced COLAs for current and future teachers, it would probably have to continue paying the cost of any supplemental COLAs for current retirees. Thus, an annual Budget Act appropriation may be necessary for some time.

Governor’s Proposal. In the 1989-90 Budget, the Governor proposes a major change in the way the state pays for STRS’ enhanced COLAs. We review the proposal in detail in the Analysis (please see Item 1920-111), and conclude that the proposal creates more problems than it solves.

PERS

We recommend that the Legislature replace the current mechanism for providing supplemental COLAs with one that is incorporated into the basic benefit structure.

The current problems with PERS’ COLA mechanisms also could be addressed by incorporating enhanced inflation protection into the basic benefit structure. As mentioned above, this could be accomplished in two basic ways. First, the benefit could be provided on top of the existing structure, which would increase the ongoing cost of funding retirement benefits. These costs, however, could be shared between employer and employees. Furthermore, these costs would be in lieu of the IDDA costs now borne by the state. Second, PERS could reduce other benefits to offset the cost of an enhanced COLA, thereby resulting in no net costs. For example, reducing the basic monthly benefit would “free up” funds that could be used to maintain purchasing power during the member’s later retirement years.

Given that either method would address the current problems with the PERS COLA mechanism, we recommend that the Legislature replace the current inflation protection method with one that is part of the basic benefit. The particular method to be selected is a policy call for the Legislature.
Summary

Our analysis indicates that there are several problems with the way STRS and PERS provide inflation protection to their retirees. Given the current COLA mechanisms, the Legislature is faced with demands to fund enhanced inflation protection on a year-to-year basis. If the Legislature wishes to provide improved COLAs to these retirees, we recommend that it do so by incorporating inflation protection into the systems' basic benefit structures. In making this policy decision, the Legislature should carefully consider the commitment involved, as any defined benefit tends to "lock in" certain costs for many years.
State Retiree Health Benefits

What Options Does the Legislature Have for Providing and Funding Health Benefits for Retired State Employees?

Summary

- In 1988-89, the state's post-retirement health benefit program will provide benefits to about 69,000 retired state employees, at a cost of over $140 million.
- Over the last 10 years, state costs for retiree health benefits have increased annually by an average of over 20 percent, and it is likely that these costs will continue to grow rapidly in the future.
- There are several major problems with the current "pay-as-you-go" retirees' health benefit program. First, while the Legislature has never explicitly committed to a given level of benefits, it may have implicitly obligated itself to fund future benefits. This implicit commitment could result in state liabilities which are open-ended and which are not paid for as they accrue. Finally, the current program does not closely link benefits with years of service and age of retirement.
- We recommend that the Legislature decide explicitly in law what it is committing to for retiree health care. Then, after the commitment is clearly defined, the costs of providing these benefits for future employees should be paid as they accrue.

In the current year, the state will pay over $140 million toward the costs of state retiree health benefits. In future years, these costs are expected to rise substantially. While, in general, the state has not explicitly guaranteed retirees the right to a certain benefit level, it may be bound to provide benefits in the future to all current employees and retirees. Therefore, given the major financial obligations entailed in any commitment—implicit or explicit—to provide retiree health benefits, the Legislature should carefully consider what benefits it will provide in the future and how they will be funded.

In this analysis, we review (1) the operation of the existing retirees' health benefits program, (2) problems with the program, and (3) different options available to the Legislature for providing and funding health benefits for state retirees.

Background

The state began providing health benefits for active and retired state employees in 1962 under the Public Employees' Medical and Hospital Care Act (PEMHCA). This program is administered by the Public
Employees' Retirement System (PERS), which also offers its health benefit plans to employees of local public agencies. In 1988-89 the program will provide health benefits to about 69,000 retired state employees, at an estimated state cost of over $140 million.

**How Do State Employees Qualify for Retiree Health Benefits?** In general, state employees qualify for retiree health benefits if they: (1) retire within 120 days of leaving state service, (2) are enrolled in a state-sponsored health plan at the time of retirement, and (3) complete a specified number of years of state employment. Employees hired prior to January 1, 1985 qualify for 100 percent of the state's monthly premium contribution after five years of state service. Employees hired after January 1, 1985 qualify for 50 percent of the state's premium contribution after five years of service. This increases 10 percent annually until employees are eligible for 100 percent of the state's contribution after 10 years. Under new collective bargaining agreements, represented employees hired after January 1, 1989 will qualify for 50 percent of the state's contribution for retiree health benefits after 10 years of service, increasing gradually to 100 percent after 20 years of state service.

In addition, the state provides health benefit coverage to the qualified dependents of retirees. Survivors of retirees are allowed to continue to receive health benefit coverage.

**What Health Benefits Do State Retirees Receive?** Retirees under the age of 65 receive the same comprehensive health benefit coverage as active employees. Retirees over the age of 65 enroll in Supplement to Medicare plans (retirees not eligible for the federal Medicare program remain in active employee health plans). The PERS' Supplement to Medicare plans are designed to pay for costs not covered by Medicare (such as copayments and deductibles), as well as provide additional services not available under Medicare (such as enhanced prescription drug and vision care coverage). In general, the state pays the entire cost of the premium for this coverage.

**Historical Costs of the Program.** In the current year, the state will spend about $140 million for health benefits for retired state employees. As Chart 1 shows, the state's cost for retiree health benefits has grown rapidly over the past decade, outpacing both the increase in the medical inflation index and the state payroll. During that time, retiree health costs have increased by an average of 20 percent annually.
The increasing costs of the retiree health benefit program are the result of: (1) premium increases and (2) growth in the retiree population.

Premium increases in the health care industry have been driven by the increasing costs of medical services, increased utilization of health services, and other factors such as advances in medical technology. Premium rates in retiree health programs are also influenced by the fact that, in general, as people grow older they have higher health care costs. For example, PERS has reported that the costs of claims for enrollees over the age of 45 are 21 percent higher than for those under the age of 45.

The retiree health benefit program also has experienced significant enrollment growth, which has contributed to the high rate of cost increases. Since 1980 the number of retired state employees covered by the program has grown from 46,700 to 68,500, an increase of 47 percent. In 1980, retired employees represented about 25 percent of total state health plan enrollment, whereas today they represent about 28 percent.

The combined effect of increased premiums and enrollment can be significant. For example, the Governor’s Budget proposes to increase state support for retirees’ health costs by $31 million in the budget year, a 22 percent increase. Of this projected growth, one-fourth is due to increased enrollment and three-fourths to premium increases.
Future Costs of the Program. Our review indicates that the cost of the retiree health benefit program is likely to continue its high rate of growth, due to increasing premiums and enrollment. The trends that have driven premium rate increases in the past are likely to continue in the future. Among the most important of these trends are the increasing costs of medical services and increased health care utilization. In addition, the number of state retirees will continue to grow rapidly in the future due in part to the demographics of the state workforce and increased life expectancies of retirees.

If, in fact, the past trends of the health benefits program were to continue into the future, then the state’s expenditures for employee compensation would be greatly affected. For instance, Chart 2 shows that if recent trends continued through 1997-98:

- Total health benefit costs (active and retirees) would surpass retirement/social security as the second most costly item in the state’s total compensation expenditures (second only to salaries), and
- The cost of health benefits for retirees would increase from 23 percent to 31 percent of the state’s total expenditures for health benefits.

These trends are even more pronounced in the 2007-08 data.

Problems with the Current Retiree Health Benefits Program

Our review of the state’s existing health benefits program indicates that it has four main problems.

State’s Commitment on Retiree Health Benefits Is Unclear. As noted above, under PEMCHA retirees receive the same benefits as current employees. It’s unclear, however, what sort of commitment—if any—this statutory provision implies about future benefits. For instance, can the Legislature change PEMHCA to modify the health benefits and/or the state contribution paid toward those benefits with regard to current retirees? Furthermore, is the Legislature “locked in” on providing future retiree benefits to current employees?

Generally, the Legislature has not explicitly committed itself to the provision of future health benefits. This may explain why retiree health benefits are supported on a “pay-as-you-go” basis through an annual Budget Act appropriation. On the other hand, Legislative Counsel advises that past legislative actions—such as the statutory linkage between employees and retirees, and the state’s funding of benefits at a high level for a long period of time—may have created a contractual commitment to future retirees.
Chart 2
Health Benefit Costs' Growing Share of the Employee Compensation Pie Assuming Past Trends Continue in the Future

Selected Years

1987-88  1997-98  2007-08

- Health benefits (active and retired)
- Salary
- Retirement/Social Security
- Other benefits

Total Health Benefits Expenditures

Assumes that salary grows by 7 percent annually, active employee health benefit costs grow by 14 percent annually, retiree health benefit costs grow by 19% annually, and continuation of current retirement and social security rates.
Any implicit commitments that have been made to current active and retired state employees, and those that will be made to new employees hired under current collective bargaining agreements, may limit the choices available to future Legislatures and will affect generations of taxpayers to come. For this reason, it is critical that the Legislature clearly define its future commitments to provide state retiree health benefits.

If the state is in fact obligated to provide some level of future health benefits, there are three additional problems with the current program.

**State May Be Committed to Fund Current Level of Benefits.** Since the state now pays for almost 100 percent of retirees' premium costs, the state could have a commitment to fund future cost increases in the retiree health program. As we described above, the cost of this program could continue to rise at very high rates. For the foreseeable future, the Legislature may have little choice but to pay the entire additional cost each year.

**Commitment to Provide Retiree Health Benefits Not Paid for When Benefits Are Earned.** As noted previously, the current health benefits program is funded on a pay-as-you-go basis. That is, the employer and employee have not contributed funds during the employee’s period of employment for the costs of providing health benefits during retirement. As a result, the state must annually appropriate funds for these costs. If the state is committed to paying retiree health benefits, it would be fiscally prudent to prefund the costs in a manner similar to retirement benefits. Prefunding ensures that: (1) future taxpayers will not be required to support costs that are incurred today and (2) the state will have sufficient funds available to fund these costs when they “come due.”

The state may face a large fiscal bill for the past, implicit commitments made to state employees. That is, if an employee’s right to retiree health benefits vests in some form even before the employee retires, then the state already has incurred a liability for the retiree health benefit costs of current employees. In 1984 a private consulting firm estimated the state’s unfunded liability for health benefits to be about $4.5 billion.

**Benefits Have Not Been Closely Linked to Service.** In the past, the retiree health benefits received by state employees have not been linked to years of service or age of retirement. For example, employees hired before January 1, 1985 generally qualify for 100 percent of the state’s premium contribution after five years of state service. Thus, an employee who worked for the state for only five years and retired at age 55 would qualify for the same retiree health benefits as an employee who worked for the state for 25 years and retired at age 65. Consequently, there is little relationship between a person’s years of service and age at retirement, and the health costs incurred by that person in retirement.
In recent years the linkage between years of state service and benefits has improved. As noted earlier, employees hired after January 1, 1985 have longer vesting periods and the state's contribution toward retiree premiums increases with years of service. Despite these significant improvements, however, benefits are not as closely linked with years of service as is the case with retirement benefits and there is no linkage with age of retirement.

What Options Does the Legislature Have for the Future?

Because of implicit commitments made to state employees in the past, the Legislature may have limited choices in the payment of retiree health benefits to current retirees, and perhaps even to current employees. Regardless of what level of retiree benefits the Legislature believes to be reasonable, it should be careful to clearly define the nature of the commitment with regard to future employees.

For instance, at one extreme the Legislature could decide not to guarantee any future retiree health benefits. It could use the existing Budget Act mechanism to fund whatever portion of retiree premium costs it could afford—or felt was appropriate to pay—in that year. To do this, however, it would have to amend PEMHCA to "unlink" current and retiree health benefits and clearly specify that employees, upon retirement, had no "right" to any particular benefit program or state contribution rate.

This approach, however, appears to be contrary to the Legislature's desire to provide employees with some security as to their health benefits in retirement. Accordingly, we offer two general alternatives to current practice which provide such benefits while at the same time addressing the problems raised above.

Defined Benefit Plan. The Legislature could provide retirees with a defined health benefit plan. This would be similar to the current program in which retirees are provided a certain level or general package of benefits. The plan, however, would have the characteristics of a retirement plan, in that benefit costs would be prefunded (through actuarially determined rates, paid for by both employer and employee) and benefits would be linked closely to years of service and age of retirement. Thus, by committing to such a specific benefit plan, the Legislature would address three of the four problems noted above.

It would not, however, necessarily resolve the problem of an open-ended commitment. If, as with existing retirement systems, the employer were the "payor of last resort," the Legislature would not know with much certainty the future fiscal liability it was incurring. As described above, the future costs of retiree health care are difficult to predict because inflation in medical services is difficult to estimate, the patterns
of health service utilization are changing, and any changes in federal Medicare policies would significantly affect state costs for retiree health care. Any and all unexpected cost increases would be borne by the state.

There are, however, a couple of ways to limit the state's fiscal commitment under a defined benefit plan:

- The Legislature could specify in statute that the state and employees share the risk for future cost increases. For example, contribution rate changes could be paid half by the employer and half by the employee.

- For represented employees, the state could collectively bargain with employees over the amount of the total cost that would be contributed by the state. This would ensure that the state and its employees begin to explicitly recognize the trade-offs inherent in funding retiree health benefits (a form of deferred income) versus current income (salaries and current benefits).

In any case, the Legislature needs to be very careful in committing to specific terms of a defined benefit plan. Because of the long-term fiscal involvement inherent in such plans, the Legislature should try to maximize its flexibility with regard to both its annual contribution rate and year-to-year adjustments in the benefit package.

If the Legislature decides to commit to a specific defined benefit plan, it probably would have to apply only to future employees. This is not only because the cost of prefunding current benefits to active employees is very high (estimated by one consulting firm to be $240 million annually). Having the plan apply only to new employees also would be the easiest way for the Legislature to "start fresh" with its explicit commitment on health benefits.

**Defined Contribution Plan.** Another alternative available to the Legislature is to provide retirees with a defined monetary contribution towards the purchase of retiree health benefits. This defined contribution plan could work similarly to existing private-sector retirement plans. For instance, the state would contribute a given amount—which could be matched by the employee—which then would be set aside in a fund to earn interest. At the time of retirement, the retiree would maintain enrollment in one of the state's group plans and use the accumulated monies in the fund to offset health premium costs over his or her retirement period.

A defined contribution plan would address all of the major problems associated with the current program:

- The state's commitment would be clearly defined.
• The state’s financial commitment would be closed-ended, as future state contributions would not be contingent on factors beyond its control (such as medical inflation and Medicare changes).

• Benefits would be paid as they are earned. The state would make contributions over the working life of employees. (Also, under a defined contribution plan, the state would never incur an “unfunded liability” as there is no “vesting” or commitment to specific benefits.)

• Benefits would be closely linked with service, as employees would receive state contributions for each year worked; and the later an employee retired, the further his/her plan dollars would go in paying premium costs.

Providing retirees with a defined contribution plan would also work well within a flexible benefits approach to employee compensation. In a flexible benefits plan the state would bargain over the total amount of employee compensation while giving employees a wide choice of different ways to spend their compensation dollars. For example, an employee could trade-off some current salary or retiree health benefit coverage in return for other benefits, such as a long-term care insurance policy. This approach would increase the state’s ability to control total compensation costs, while giving employees more choice in determining the mix of benefits that will best meet their needs.

The main disadvantage to a defined contribution plan is that it leaves retirees more at risk for future cost increases in the program. While employees could match the state’s annual contributions in order to cover a certain amount of expected retirement health costs, as retirees they would have to pay for any unexpected cost increases from their own resources.

Summary

If past trends continue, the cost of retiree health benefits will rise dramatically in future years. With regard to current employees and retirees, it’s unclear the extent to which the state can affect these costs. With regard to future employees, it is vital that the Legislature decide explicitly in law what it is committing to for annuitant health care. Then, after the commitment to provide retiree health benefits is clearly defined, the state should pay the costs of providing these benefits for future employees as they accrue.
Implementation of the PERS-CARE Health Plan

Will PERS-CARE Be an Affordable Health Plan Option for State Employees in the Future?

Summary

- The PERS Health Benefits Program offers health benefit coverage to employees of the state and various local public agencies. Total enrollment, including employee dependents, was about 660,000 as of July 1988. In 1987-88 total premium costs were about $578 million.
- In recent years the program has experienced rapidly increasing premiums. Fee-for-service plans have been one of the factors driving premium increases, as these plans are far more expensive than Health Maintenance Organization (HMO) plans.
- To help contain premium increases, PERS consolidated its existing fee-for-service plans into a new program called PERS-CARE, a self-funded state-run plan which contains various cost containment features.
- PERS-CARE faces significant obstacles to controlling future cost increases, as the plan has a much older membership and the basic fee-for-service structure of the plan does not provide strong incentives to control costs. Because these factors are not easily remedied, it is uncertain whether PERS-CARE will be an affordable health plan option in the future.
- To assist the Legislature in monitoring the progress of the PERS-CARE health plan and to provide PERS with information that will help it manage the plan (and all other plans), we recommend the enactment of legislation requiring the PERS Health Benefits Program to develop a comprehensive management information system.

In recent years, the Public Employees' Retirement System (PERS) Health Benefits Program has experienced rapidly increasing premium costs. One of the driving forces behind the cost increases has been high premium rates in its fee-for-service plans. To help address this problem, PERS recently chose to consolidate the fee-for-service plans into one major plan, called PERS-CARE. PERS-CARE is self-funded by the state, and contains various cost containment features.

In this analysis, we (1) describe the state's health benefits program, (2) evaluate recent cost patterns which led to the creation of PERS-CARE, and (3) evaluate whether PERS-CARE will be successful in controlling these increases.
The State’s Health Benefits Program

The state provides health benefit coverage to its active and retired state employees under the Public Employees’ Medical and Hospital Care Act. This program, which is administered by PERS, also provides health benefit coverage to employees of various local public agencies. The PERS health benefits program is large, covering about 280,000 current and retired state and public agency employees (as of July 1988). Total enrollment, including employee dependents, is 660,000. In 1987-88 total premium costs were about $578 million.

Chart 1 shows the composition of the plan. It indicates that almost three-fourths of enrollees are “active” employees, and one-fourth are retired. It also shows that 85 percent of enrollees are state members, compared with 15 percent local members.

Chart 1
PERS Health Benefits Program Enrollment*
As of July 1988

*Figures do not include dependents of employees.

In recent years, the number of retirees and public agency members has grown significantly. In 1973, retirees represented 19 percent of the plan, while in 1988 they represented over 27 percent. Since 1980, the number of retirees has increased by 25,000, or 51 percent. Public agency enrollment has grown even faster, increasing from about 20,000 employees in 1983, to over 40,000 in 1988. These employees represent over 400 different public agencies.
The PERS Health Benefits Program offers over 30 health plan options to employees. The options fall in the following categories:

- **Fee-For-Service/Preferred Provider Plans.** In a fee-for-service plan an insurer agrees to pay specified percentages of medical services bills. The employee has virtually unlimited access to these services, and may choose the doctor of his or her choice. A preferred provider option includes incentives for employees to use a preselected group of health care providers who have agreed to provide their services at a discount. Prior to PERS-CARE, the major fee-for-service plans were operated by Blue Cross, Blue Shield and Cal-West.

- **Health Maintenance Organizations (HMOs).** HMOs generally follow one of three models: (1) staff model, in which services are provided by the HMO's own in-house staff; (2) group practice model, in which services are provided through a medical group; or (3) an independent practice association, in which an HMO provides services through contracts with independent medical providers. In many cases, HMOs provide health care service for a per-person prepaid fee. Normally, the employee is covered only for treatment prescribed by an HMO doctor.

- **Association Plans.** These plans are derived from specific collective-bargaining negotiations. Membership is confined to a limited group of employees, such as highway patrol officers.

**Why Was PERS-CARE Created?**

PERS-CARE was created primarily to help control the cost of the PERS fee-for-service health plan option. In the past, these fee-for-service options have been more expensive than other plans offered by PERS, and recently their cost has increased at a high rate. In 1987-88, for instance, fee-for-service costs increased by nearly 20 percent, while HMO costs increased by 4.8 percent. In the current year, premium costs for the fee-for-service plans are projected to increase by over 31 percent, compared to HMO premium increases of 7.5 percent.

Chart 2 shows recent premium costs of selected fee-for-service plans (Blue Cross/Blue Shield and PERS-CARE), and one HMO plan (Kaiser North).

The chart shows that the fee-for-service plans cost considerably more, and require employees to contribute toward the premium costs. In contrast, employees in the HMO plan generally have not had to incur any out-of-pocket premium costs. The plans shown are representative of the health benefits program as a whole, as fee-for-service plans are significantly more expensive for the state and employees than HMOs.

The high cost of the fee-for-service plans has affected the state health benefits program by (1) increasing its overall costs, (2) increasing the state's contribution toward these costs, and (3) causing enrollments to shift from fee-for-service options to HMOs.
Increase in Overall Costs. Due in part to the cost of its fee-for-service plans, the PERS Health Benefits Program has experienced rapidly increasing premium costs in recent years. This in turn has led to increasing costs for the employers who participate in the program. For example, between 1979-80 and 1987-88 the state per-employee premium cost has risen annually by an average of nearly 12 percent and total state premium costs increased annually by an average of almost 16 percent. These increases compare to an annual average increase of 6.8 percent for the state payroll, and an annual average increase of 8.6 percent for the cost of medical services (California medical inflation index) over the same time period.

Increase in State Costs. The high premium costs of the fee-for-service plans have also had a substantial effect on what the state contributes toward premium costs. The state’s contribution for its employees is based on an average of the premiums of the four plans with the largest enrollment (which has always included at least one fee-for-service plan). Consequently, the high premium cost of the fee-for-service plans (one of the top four) raises the state contribution for all plans.
**Enrollment Shifts.** As the employee premium cost of the fee-for-service plans has increased, employees have shifted to less expensive HMO plans. Chart 3 illustrates the changing enrollment patterns in the state's program since 1983-84. It shows that enrollment in fee-for-service plans has dropped from almost half of the total in 1983-84 to about 15 percent today. In general, it is the younger employee who shifts enrollment to an HMO plan because they are less able, on average, to afford the higher premium cost in fee-for-service plans. Also, older employees are reluctant to change to an HMO because they are accustomed to traditional fee-for-service plans, and may have long-standing relationships with particular medical care providers. In addition, some retirees live out-of-state and thus, have no alternative to a fee-for-service plan.

**Chart 3**

**PERS Enrollment by Type of Health Plan**

1983-84 through 1988-89

- HMO
- Fee-for-Service
- Preferred Provider Organization

*a Excludes association plans.

**The PERS-CARE Strategy.** In order to stabilize premium increases and enrollment patterns, PERS, on January 1, 1989, consolidated the Blue Cross, Blue Shield, and Cal-Western fee-for-service plans into PERS-CARE, a self-funded fee-for-service plan with a preferred provider option. PERS had previously obtained legislative approval for the self-funding of the plan in Ch 1129/87 (SB 908, McCorquodale). PERS-CARE includes a utilization review component, and some minor plan design changes. These changes were based on a 1984 study provided by William
M. Mercer, a private consulting firm. Mercer recommended in the study a number of cost-containment measures, most of which were incorporated into PERS-CARE (estimated savings are based on 1984 premiums):

- **Consolidation and Self-funding.** Mercer recommended consolidating the fee-for-service plans into one major plan, which would then be self-funded by the state. By self-funding the plan, the state, and not an insurance company, retains the risk of paying the cost of claims which have been incurred. Self-funding should reduce costs because premium taxes and risk charges are eliminated, and the state retains investment earnings on contributions. *Estimated annual savings: $9.5 million.*

- **Utilization Review.** This is a cost containment feature which attempts to reduce the use of health care believed to be unnecessary or inappropriate. *Estimated annual savings: $8 million.*

- **Preferred Provider Networks.** Preferred provider networks offer incentives for employees to use a limited group of health care providers who agree to provide their services at a discount. *Estimated annual savings: $3 million.*

- **Various Plan Design Changes.** These strategies involve changing the structure of a plan to encourage the more efficient use of health services. Deductibles, copayments, and benefit changes are some typical ways to accomplish this goal. *Estimated annual savings: $4 million.*

**What Does the Future Hold for PERS-CARE?**

PERS-CARE is currently the most expensive health plan offered to state employees. Whether it can continue to be an affordable health plan option in the future will depend on its success in achieving savings from consolidation, self-funding, utilization review, preferred provider networks, and plan design changes. Yet PERS-CARE faces two major obstacles to its success: (1) the increasingly older age of the PERS-CARE enrollment will make cost containment difficult, and (2) the basic design of a fee-for-service plan does not encourage cost containment.

**Demographics of PERS-CARE Will Continue to Make Cost Containment Difficult.** A review of enrollment data indicates that the fee-for-service plans in PERS historically have attracted an older population than have the other plans. Chart 4 shows the percent of retired employees in representative fee-for-service and HMO plans since 1983-84. It shows that the fee-for-service plans have attracted a much higher percentage of retirees (currently about half of total enrollment). In general, as a person ages their medical costs increase because they tend to make greater use of health care services. Because fee-for-service plans have had a significantly older enrollment than the HMO plans, this is one important factor that explains the higher cost of their premiums.
Recent information indicates that this trend has grown worse in the PERS-CARE plan. In September of each year, PERS has a one-month open enrollment period during which employees are allowed to change from one health plan to another. Results of enrollment changes as of January 1989 indicate that the plan has lost over 11,800 enrollees, or 13 percent of its membership. More importantly, the loss in membership has been among active, and, therefore, younger employees. The plan lost 12,600 active enrollees, or 25 percent of its active enrollment, while it gained about 800 retired enrollees, an increase of about 1.9 percent in its retired enrollment. These trends indicate that the demographics of the plan will continue to be an obstacle to containing premium increases.

Structure of Fee-for-Service System Makes Cost Containment Difficult. Another reason that the fee-for-service plans have higher costs than HMOs relates to the basic structure of the plans. The fee-for-service system does not give doctors and hospitals strong incentives to contain costs. In fact, there is a financial incentive in a fee-for-service plan for health care providers to give a patient more expensive care, which in turn results in higher premium costs.
In general, HMOs have both an incentive and a greater ability to contain costs. In many cases, HMOs are paid a per-person prepaid fee which gives the HMO an incentive to contain costs. HMOs also have more control over their health care providers (who in some cases are the employees of the HMO), which gives them more ability to achieve savings.

While the utilization review, preferred provider option, and plan design features incorporated in PERS-CARE are intended to make it a more cost-efficient delivery system, it is unclear to us that they will be enough to make PERS-CARE a financially affordable alternative to HMOs—especially for active employees. Given these concerns, the Legislature should monitor carefully the progress of the PERS-CARE health plan.

**Monitoring the PERS-CARE Health Plan**

*We recommend the enactment of legislation requiring the Public Employees' Retirement System Health Benefits Program to develop a comprehensive management information system and to report annually to the Legislature on health plan expenditures.*

In its 1984 report, Mercer stressed that PERS should “manage” its health care expenditures by developing appropriate analytical data. To accomplish this, Mercer recommended that PERS develop a comprehensive management information system. The data supplied by such a system would allow the Legislature to monitor the progress of PERS-CARE and give PERS information on expenditure patterns that would allow it to determine how the efficiency of the health benefits program could be improved. This information is also vital for PERS to assess the effectiveness of the cost containment efforts it has implemented in the PERS-CARE plan.

To be most useful to the Legislature and PERS, however, the management information system should cover every plan within the health benefits program in order to be used for comparative purposes both between health plans within the program, as well as comparisons with regional or national trends. Data could be collected on the following major expenditure categories:

- Place of service (for example, hospital, physician, office, independent lab);
- Type of service (for example, surgery, other physician care, mental health, drugs);
- Five-year age categories, by sex, and employee and dependent status; and
- Major geographic areas (for example, Los Angeles, bay area, Sacramento).
Once gathered, the information would be analyzed by PERS and used to evaluate trends, identify problems, and project future experience patterns.

To date, PERS has not fully implemented a management information system. Therefore, it does not have much of the analytical information needed to ensure the efficient operation of the health benefits program. Before implementation of such a system can take place, PERS will require a long lead time (perhaps as much as a year) to negotiate with health plan carriers over obtaining the basic data necessary for a management information system. Therefore, it is important that action be taken as soon as possible so that the process of developing a management information system can begin.

In addition, given the high cost of PERS-CARE, it is important that the Legislature closely monitor the progress of the plan in the near future. Information developed under the management information system should be shared with the Legislature to allow for proper legislative oversight. To accomplish this, PERS could report annually on its findings, and on corrective action being taken to improve the efficiency of the health benefits program.

Accordingly, we recommend the enactment of legislation requiring the PERS Health Benefits Program to develop a comprehensive management information system and to report annually to the Legislature on the following major expenditure categories: (1) place of service, (2) type of service, (3) five-year age categories, by sex, and employee and dependent status, and (4) major geographic areas. Health plan carriers should have the basic data necessary for the implementation of a management information system already available. PERS currently has existing cost containment reporting requirements which could be adapted to include this information.