LAO POLICY BRIEF

The 2010–11 Budget:

The Governor's Employee Compensation Proposals

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This report discusses some key issues facing the Legislature in the employee compensation area of the budget. In 2009-10, the state has achieved significant savings due to the Governor's furlough program, which is being challenged in many court cases. For 2010-11, the Governor proposes various measures to reduce state personnel costs, including shifting pension contribution costs from the state to employees, unallocated reductions in personnel budgets of departments, and an across-the-board salary reduction for employees. These proposals would result in $2.5 billion in savings ($1.4 billion General Fund).

We believe that employee compensation reductions are necessary due to the magnitude of the budget problem. Nevertheless, some of the administration's proposals would face legal challenges or otherwise may be difficult to implement. Consequently, we recommend that the Legislature focus efforts to reduce compensation costs on pay reduction options.

BACKGROUND

The state workforce consists of approximately 356,000 personnel years (PYs). (A PY is roughly equivalent to one full-time equivalent employee.) Total state payroll, including university personnel, is now roughly $24 billion per year. The state's two university systems employ just over one-third of total PYs. Excluding university employees, around $10 billion of General Fund expenditures—about 12 percent of the budget in the *2009-10 Budget Act*—relate to state personnel costs, including payroll and state contributions to employee pensions, health, and other benefits.

About two-thirds of this $10 billion in state personnel costs funded by the General Fund are within the California Department of Corrections and Rehabilitation (CDCR).

Governor Proposes $2.7 Billion in Employee Compensation Cost Reductions. The Governor's furlough program is set to expire at the end of 2009-10. In its place the administration proposes $2.7 billion ($1.5 billion General Fund) in 2010-11 compensation cost reductions, as shown in Figure 1 (see next page). Of this $2.7 billion total, $2.5 billion ($1.4 billion General Fund) relates to what the administration terms its "5/5/5" package:

- Shifting a portion of pension contributions from the state to employees.
- Unallocated reductions in personnel costs.
- Across-the-board salary reductions.

Figure 1

Governor's Major Employee Compensation Proposals

(In Millions)

	Overall Savings	General Fund Savings
5/5/5 Proposal		
Pension contribution rate shift	$724	$406
Unallocated department personnel reduction	802	450
Salary reduction	945	530
Subtotals	($2,472)	($1,385)
Other Proposal		
Health benefit administration change	$217	$153
Totals	**$2,689**	**$1,538**

In addition, the Governor proposes moving health benefit administration for state employees out of the California Public Employees' Retirement System (CalPERS) to another state department to achieve savings in health benefit costs. We discuss and comment on these proposals in more detail below.

5/5/5 EMPLOYEE COMPENSATION PROPOSAL

Shifting Pension Contribution Rates

Proposal

Increase Employee Pension Contributions by 5 Percent of Pay. The budget assumes legislative action to increase employees' pension contributions to CalPERS by 5 percent of payroll—resulting, for example, in Miscellaneous Tier 1 employees paying approximately 10 percent of their pay to the system and correctional officers and California Highway Patrol (CHP) officers paying approximately 13 percent, as shown in Figure 2. This would reduce state pension contributions by an equal amount: $724 million ($406 million General Fund).

LAO Comments

Pension Contribution Shift Is Very Risky. There are serious concerns about the the legal viability of the Governor's proposed 5 percent shift in pension contributions from the state to employees—particularly if the shift is accomplished through the legislative process, instead of through collective bargaining. Courts have repeatedly negated attempts to create substantial savings from altering pension payments for current employees without offering comparable offsetting benefits in exchange.

Options for Consideration

Pension Reform for New Employees. Unlike obligations for current employees, the Legislature has much greater flexibility in defining benefits for future employees. The Legislature could make any change it wishes in benefits or pension contributions of state employees hired in the future.

Recommendation

Reject Pension Contribution Shift. In light of the other risky elements of the Governor's budget package and the need to pass a credible, balanced budget, we recommend the Legislature reject the administration's pension contribution proposal.

Unallocated Reductions in Personnel Costs

Proposal

Unallocated Reductions of 5 Percent. The budget includes what the administration describes as a "workforce cap"—an unallocated reduction in personnel costs to be achieved through a 5 percent increase in salary savings. Each department would determine how to meet its particular personnel savings target. Most of the savings is expected to be achieved through attrition and vacancies. Constitutional offices are not included in this reduction. The budget assumes $802 million ($450 million General Fund) from this unallocated reduction.

LAO Comments

Unallocated Reductions Create Difficulties for Department Operations... Generally, unallocated reductions result in varying impacts to public services offered by departments. The state's current-year budget already relies on significant unspecified reductions, where departments are using savings from vacancies and attrition to fund their programs within existing appropriations. It is unclear, therefore, if and how departments would achieve these additional proposed reductions, and, if they do achieve them, what state priorities will be stressed and which activities will be sacrificed. Further, unallocated reductions effectively remove the Legislature from the decision-making process—leaving departments to make reductions based solely upon the administration's priorities rather than the Legislature's priorities.

...Especially Corrections. As mentioned above, personnel costs in CDCR represent a majority of such spending funded by the General Fund (not including university personnel). We estimate that CDCR's budget would be reduced by about $300 million under this unallocated reduction proposal. These savings would be in addition to the $1.1 billion in other corrections solutions proposed by the Governor. Moreover, this department already is struggling to implement cuts in the 2009-10 budget package. Without major changes in sentencing policy, operations of the Receiver, or other operational changes, we do not believe CDCR would be able to implement an unallocated reduction of this magnitude.

Unallocated Reductions Only for Personnel Costs? Initiating unallocated reductions provides departments with some flexibility in achieving desired cost savings. Applying unallocated reductions only to personnel costs, as

Figure 2

Pension Contribution Rates

	Employee Rate[a]		State Employer Rate[b]	
	Current Policy	Governor's Proposal	Current Policy	Governor's Proposal
Miscellaneous Tier 1	5%	10%	17.5%	13.3%
Miscellaneous Tier 2	—	5	17.4	13.0
Industrial	5	10	17.6	13.8
Safety	8	13	18.3	14.7
Peace Officers and Firefighters[c]	8	13	26.4	22.1
Highway Patrol	8	13	29.2	25.1

[a] Approximate.

[b] Estimated rates for 2010-11, as stated in Control Section 3.60 of the proposed *2010-11 Budget Bill.*.

[c] The state pays a portion of some employees' contributions.

the Governor proposes, and *not* to departmental costs for operating expenses and equipment (OE&E) limits the flexibility departments may have in achieving savings. Savings from OE&E budgets might be achieved through delaying or reducing costs in equipment, supplies, training, travel, postage, personal services contracts, or other operating expenses. In some cases, seeking reductions in personnel costs but not in OE&E may create unintended incentives for departments to seek personal services contracts to complete workload.

Unallocated Reductions for Special Funds and Federal Funds? There are many cases in state government where pay and benefit changes need to be implemented uniformly across classifications and across departments, regardless of fund source (that is, whether the employee is paid from the General Fund or other funds). For example, pay and benefit changes typically need to be implemented uniformly to avoid incentives for employees in the same classifications to migrate to better-paying departments, while leaving lower-paying departments struggling to refill those positions. It is unclear, however, why the administration chooses to implement the 5 percent unallocated cuts to parts of personnel budgets not funded by General Fund. The administration's rationale communicated to our office—that the overall size of state government is too large—is arbitrary and not based on any reviews of specific program workloads or personnel effectiveness.

Recommendations

Avoid Unallocated Reductions, Particularly for CDCR. We recommend that the Legislature avoid making unallocated reductions for departments. If the Legislature feels that it should reduce the size of the workforce, we recommend that the Legislature weigh its own priorities, carefully analyze the operations of each program and department (including OE&E expenses), and either eliminate or reduce the scope of programs, which often would necessitate reductions in the size of the state workforce. In particular, because CDCR likely would be expected to generate a majority of the General Fund unallocated reductions under this proposal and the difficulties CDCR has experienced in implementing current savings strategies, it is imperative that the Legislature consider the specfic policies and operations of CDCR if it wants to reduce General Fund costs of this department's workforce. Without specific changes in prison policies and operations, achieving savings through unallocated reductions for CDCR would prove illusory.

No Unallocated Reductions for Special and Federal Funds. The administration has not put forward a credible rationale why unallocated reductions should be extended to personnel expenses funded by special funds, federal funds, or other nongovernmental funds. If the Legislature chooses to implement unallocated personnel reductions, we believe that it should do so only for General Fund personnel budgets in departments.

Salary Reductions

Proposal

5 Percent Salary Reduction. The budget assumes $945 million ($530 million General Fund) in savings through a 5 percent across-the-board reduction in employee salaries—effective July 1, 2010 (after the expiration of the Governor's furlough order).

Administration's 5/5/10 Trigger Proposal. In the event that the federal government fails to provide the targeted amount of funding or flexibility measures that is the basis of the Governor's budget, the administration proposes an additional 5 percent salary decrease. This additional decrease would produce savings of $907 million

($508 million General Fund). (This estimate is slightly less than the figures in the section above because the salary base would be lower after the implementation of the base 5/5/5 proposal.) Reflecting the total 10 percent salary reduction, the administration calls its trigger proposal the "5/5/10" proposal.

LAO Comments

Legislature Has Broad Powers in Setting Employee Compensation Policy. The Legislature possesses broad powers—through budget appropriations, oversight, and legislation—to determine salary levels and benefits for state employees and to review the application of these policies.

Governor Has Broad Discretion for Excluded and Exempt Employees. In statute and in practice, the Legislature has delegated the general authority to establish salary and benefit schedules for essentially all excluded and exempt employees (which include managers, supervisors, appointees, and staff that have human resources duties) to the Department of Personnel Administration (DPA). In other words, the administration could implement its salary reduction for excluded and exempt employees without further legislative action. (Certain exempt appointees, including departmental directors, have salaries that are governed by statute.) In recent years, however, the state generally has tried to guard against "compaction" problems—that is salaries for supervisors and managers that overlap with senior rank-and-file employees—by targeting a minimum pay differential between these groups of 5 percent.

Dills Act Governs Collective Bargaining Process for Represented Employees… The Legislature passed the Ralph C. Dills Act, which governs collective bargaining, in 1977. Under the Dills Act, DPA represents the Governor in negotiations with unions representing the state's collective bargaining units. The Dills Act was crafted to be consistent with the Legislature's constitutional "power of the purse." Specifically, the act provides that *any* provision of a memorandum of understanding (MOU) requiring the expenditure of funds may not become effective unless approved by the Legislature in the annual budget act, thus reserving ultimately for the Legislature the authority to set salary levels. Also, generally when MOUs expire, the "evergreen" provision of the Dills Act extends the provisions of the most recent contract until a new contract is approved. Currently, only one bargaining unit—CHP officers—has an agreement that has not expired (it is set to expire in July 2010).

…But Process Dysfunctional in Unprecedented Budget Climate. Under the current budget climate, with state employee unions at odds with the Governor (as discussed in the box on page 6 discussing the furlough policy), and given the unprecedented level of personnel cost cuts sought by the administration, it is virtually impossible for the administration and state employee unions to reach the level of savings assumed in the Governor's budget through bargaining. Factors contributing to this difficult climate include:

- ***The State Has Little to Give.*** Collective bargaining is a process of give and take. In order to gain terms and conditions such as those sought by the administration, the state usually must give bargaining units something of roughly equal value—which could include salary increases, health contribution increases, pension increases, layoff and grievance processes changes, and other workplace policy changes. With about a $20 billion budget deficit, the state has little of value it can give now. With years of structural budget problems looming, the state is unlikely to have anything of comparable value to give in the near future. Furthermore, with substantial unfunded liabilities in the pension system and health retiree system, the state cannot afford to give anything substantial over the longer term. With so little to give now or in the future, it is unlikely that the administration will be able to bargain for the level of personnel savings that the Governor is seeking.

- ***Last Year of Governor's Term Puts Administration in Poor Position.*** In the last year of his term, the Governor is in a poor negotiating position with state employee unions. There is a great incentive for bargaining units to resist making concessions if they think they may have better bargaining prospects with the next Governor.

Salary Reduction Offers Greatest Legislative Flexibility. Under the Dills Act, the Legislature has reserved for itself its constitutional powers to appropriate funds and, therefore, the right to set salary levels for represented employees at the level it desires. In addition, because the evergreen law that extends provisions of an expired MOU is statutory, the Legislature may change, amend, or temporarily waive that law along with any other conflicting statutes.

Options for Consideration

We present below alternative options and recommendations for reducing state payroll costs.

Vary Employee Pay Reductions by Employee Group. While it would be a laborious task, the Legislature should consider varying the size of pay level reductions by bargaining unit or classification for represented employees. This would give the Legislature some ability to prioritize those positions with important staffing problems. In our view, important staffing issues that may warrant some protection include those affecting at least two distinct groups:

- Groups of employees within programs where problems in filling positions can *clearly* be attributed to uncompetitive compensation levels (such as certain scientific classifications).

- Groups of employees in programs that are under federal consent degree for staffing problems (including certain doctors and nurses in the state's mental health facilities).

Conversely, the Legislature could reduce pay disproportionately for those groups of employees where the labor market impacts would be less pronounced—for example, where such groups are currently compensated at higher levels than

Furlough Lawsuits Remain an Ominous Budget Risk

There have been several dozen lawsuits challenging the Governor's authority to implement his furlough program in 2008-09 and 2009-10. The furlough program is credited with over $2.5 billion of state savings over those two fiscal years, most of which has been credited to the General Fund. If the state ultimately loses these lawsuits, it might have to pay several hundred million to billions of dollars in back pay and penalties. Because the administration is likely to appeal the decisions to the California Supreme Court, final judgment may be delayed until 2011-12 or later. Therefore, the ramifications of the furlough cases and other recent employee compensation actions add further downside risk to the budget in future years.

comparable other government or private-sector employees. We note that any reduction in pay should be applied equally across all employees in a given classification. Implementing a policy that results in different pay for employees in the same classification would create strong incentives for workers to move across departments for better pay, and, thus, create unintended difficulties for some departments.

Possible to Try Using Collective Bargaining. We described above the inherent limitations of collective bargaining in today's fiscal environment. Despite these limits, the Legislature may wish to give the bargaining process a window to provide input into the difficult task of reducing employee compensation. For instance, the Legislature could adopt across-the-board salary reductions but provide the administration and bargaining units with some time to develop alternatives. The outcome of negotiations might lead to something similar to this year's furlough program—where employees are at least getting some compensation (in the form of time off) in exchange for state savings. The Legislature would still be able to review any bargained agreements to ensure that they were consistent with legislative priorities. Such an approach would need to be adopted relatively soon to allow sufficient time for bargaining prior to the start of the fiscal year. (A similar collective bargaining option was included in the 2003-04 budget package.)

Pay Cuts May Be Permanent or Temporary. The administration's proposals appear to envision the 5/5/5 cuts as ongoing solutions. The Legislature instead could consider temporary salary reductions. One option would be to gradually increase salaries to pre-furlough (or somewhat reduced) levels. This would allow the Legislature to avoid steep increases in costs over a one-year period. Similarly, the Legislature could consider varying the expiration of salary reductions by classification or bargaining unit depending on its priorities.

Recommendations

Pursue Salary Reductions for Rank-and-File and Excluded Employees. We believe that reductions in employee compensation will be necessary given the state's fiscal condition. Because of the practical and legal barriers to the Governor's proposed pension and unallocated reduction proposals, reducing employee pay is the most viable option available to the Legislature. As discussed above, the Legislature has several options to ensure such reductions reflect its priorities to the greatest extent possible. In many respects, the total amount of salary reductions that the Legislature will need to target will depend on the other choices that the Legislature makes in putting together a budget package.

The administration has much broader discretion in setting compensation for excluded and exempt employees. If the Legislature pursues salary reductions, we recommend that it set a salary reduction target for those employees and allow the administration to implement the reductions as it sees fit. This would allow the administration to focus resources to management classifications with the most severe recruitment and retention issues.

OTHER EMPLOYEE COMPENSATION PROPOSALS

Employee Health Benefit Administration

Administration Advances Last Year's Proposal Again. The Governor's budget proposal would allow the administration to move the management of health benefit programs for state employees and retirees out of CalPERS to "another authorized entity of the state" (presumably DPA or perhaps a newly formed department). The administration assumes that this would produce savings of $217 million ($153 million General Fund) in 2010-11. The Legislature determines policies for health benefit programs for state employees and retirees and gives the responsibilities for managing these programs to CalPERS.

Proposal Worth Considering, but Unlikely to Produce 2010-11 Savings. As we wrote about an identical proposal the *2009-10 Budget Analysis Series: General Government* (see page GG-9), by delegating the administration of health benefits—which the state itself bargains for—to a semi-independent entity, the Legislature has diminished its ability and that of the administration to direct state personnel health policies and costs. Exploring a move of health benefit programs from CalPERS to DPA makes sense, as we first observed in 1985. We are skeptical, however, that a transition of the administration of health plans involving hundreds of thousands of employees can be achieved in a one-year timeframe. Furthermore, the administration assumes large cost savings that would, by necessity, involve large "cost-shifting" (through increased co-payments, deductibles, or similar charges) from the state to employees and retirees. The Governor's proposal provides no meaningful detail on what changes would be implemented in health plans to achieve these considerable savings.

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This report was prepared by Diego Martín, and reviewed by Jason Dickerson. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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