LAO
70 YEARS OF SERVICE

January 11, 2016

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative (A.G. File No. 15-0111) that would cap total annual compensation for executives at specified hospitals—including private nonprofit and for-profit hospitals—at the level of compensation received by the President of the United States (currently set at $450,000).

BACKGROUND

Two Broad Categories of Hospitals: Public and Private. Hospitals generally fall into one of two broad categories: public or private. A public hospital is operated by the state of California, a county, a city, the University of California, a local health district or authority, or any other political subdivision of the state. A private hospital is typically operated by a corporation (either for-profit or nonprofit). In California, about 82 percent of hospitals are private hospitals and about 18 percent of hospitals are public hospitals. Relative to private hospitals, public hospitals tend to deliver a disproportionately large percentage of medical care to uninsured and low-income persons in California. Public hospitals are mainly funded with federal, state, and/or local government funds. District hospitals are public hospitals managed by health care districts—a type of special district authorized by state law to operate hospitals and other health care facilities in underserved areas.

Two Broad Categories of Private Hospitals: For-Profit and Nonprofit. For taxation purposes, there are two broad categories of private hospitals: for-profit and nonprofit. Of the private hospitals in California, about 30 percent are for-profit and about 70 percent are nonprofit. The for-profit hospitals pay corporate income taxes to the state. Nonprofit hospitals are exempt from state corporate income taxes and local sales and property taxes. The tax exemptions for nonprofit hospitals are intended to allow them to use the funds that would have been paid in taxes to provide patient care, invest in their facilities and equipment, and implement other measures that would be beneficial to their delivery of health care services, such as providing charity care. Charity care is generally considered to be care provided for which payment is not expected and patients are not billed.

Executive Compensation at Private Hospitals. A recent study published in the Journal of the American Medical Association Internal Medicine found that nonprofit hospital Chief Executive Officers (CEOs) nationwide earned almost $600,000 on average in 2009; although, earnings ranged from less than $50,000 to over $3 million. The CEOs managing nonprofit teaching hospitals and managing nonprofit hospitals in urban areas were paid more than other CEOs. As of 2013, it is estimated, based on tax filings, that there were a few hundred nonprofit hospital executives in California earning annual compensation above $450,000. The compensation of executives at for-profit hospitals is not well-documented, therefore, the number of for-profit hospital executives in California earning annual compensation above $450,000 is unknown.

Executive Compensation at District Hospitals. As of 2014, there were 39 district hospitals in California. Given the relatively small number of district hospitals, there are only a handful of executives at district hospitals who earn annual compensation above $450,000.

PROPOSAL

This measure would impose a cap on compensation for executives at all private hospitals and district hospitals (hereafter referred to as "covered hospitals"), impose new data reporting requirements on covered hospitals, impose new administrative responsibilities on the Attorney General (AG), and give the AG authority to oversee and enforce the provisions of this measure.

Caps Executive Compensation at Covered Hospitals

Executive Compensation May Not Exceed President of the United States' Compensation. This measure imposes a cap on total annual compensation paid to covered hospital executives at the level of compensation received by the President of the United States. Currently, this level of compensation is $450,000 per year. "Executives" are defined under this measure to include individuals whose primary responsibilities are executive, managerial, or administrative, for example CEOs or chief financial officers. "Total annual compensation" capped by this measure includes, but is not limited to, wages, salary, paid time off, bonuses, incentive payments, lump-sum cash payments, loan forgiveness, housing payments, travel, meals, reimbursement for entertainment or social club memberships, the cash value of housing or automobiles, scholarships or fellowships, the cash value of stock options or awards, and payments or contributions to severance. Total annual compensation does not include the cost of health insurance or disability insurance, or contributions to health reimbursement accounts.

New Data Reporting Requirements for Covered Hospitals

Covered Hospitals Must Report Levels of Executive Compensation. This measure requires covered hospitals to file an annual report to the AG that includes the names, positions, and total annual compensation of all executives who received annual compensation that exceeded the level of compensation received by the President of the United States and all former executives who received severance compensation in the given year that exceeded the level of compensation received by the President of the United States. This report must include a breakdown of the wage and nonwage compensation provided, identify all entities that contributed to the compensation, and identify the amounts of the contributions. This information must also be made publicly available on a website and on request from any member of the public.

New Oversight Responsibilities for the AG

Establish Requirements for Data Reporting. This measure makes the AG responsible for determining the format that covered hospitals must follow when reporting data on executive compensation.

Enforce Executive Compensation Cap. This measure allows the AG (or any state taxpayer) to bring a civil action against a covered hospital for violating this measure. Civil actions may be brought to assess a civil penalty, revoke a nonprofit hospital's corporate status as a nonprofit corporation, and/or revoke a hospital's tax-exempt status under state tax law. This measure allows the AG to assess civil penalties of up to $200,000 for each intentional violation. For violations that are determined to be non-intentional, civil penalties of up to $100,000 for a first offense and up to $200,000 for all subsequent offenses may be assessed.

Supervise Noncompliant Hospitals. This measure allows the AG to supervise covered hospitals that fail to comply with the executive compensation cap. The AG may appoint any person to serve as its representative on the board of directors of any corporation that owns, operates, or controls a noncompliant, covered hospital. Nonprofit religious corporations and nonprofit corporations incorporated outside of California are excluded from this provision.

The AG May Assess Fees to Cover the Costs of Implementation and Enforcement. This measure gives the AG the authority to assess reasonable fees on covered hospitals to cover its administrative costs to implement and enforce the measure. These fees will be assessed annually and must be submitted with the annual report from each covered hospital.

FISCAL EFFECTS

Administrative Costs for AG, With Authority to Recover Costs Through Fees Assessed on Covered Hospitals

This measure creates additional workload for the AG to implement and enforce the measure. The increased workload would result in annual costs for the AG in the low millions of dollars. Under the measure, the AG is given the authority to recover costs from fees assessed on covered hospitals.

Other Potential, but Likely Minor, Net Fiscal Effects on State and Local Governments

The cap on executive compensation could have fiscal effects on state and local governments in several different ways, depending on the behavioral responses of the covered hospitals to the cap. However, these behavioral responses are highly uncertain, such that the potential resulting fiscal effects are equally uncertain. While uncertain, these effects overall are likely to be relatively minor on net.

Here we provide a few examples of the potential behavioral responses of covered hospitals, recognizing that there are many more potential responses. These potential responses depend, in part, on the covered hospital's tax status (taxable or tax-exempt). For example, consider the case of a private nonprofit hospital that is not subject to the corporate tax. In such case, the state receives tax revenues only from the hospital's employees, not from the hospital itself. To the

extent the cap on executive compensation reduces the amount of income earned by certain employees of covered hospitals, state personal income tax revenue collected from these employees would decrease. However, the hospital could respond to the cap on executive compensation in a way that generates additional tax revenue, potentially offsetting the state personal income tax revenue decrease. For example, the hospital could reallocate funds that were previously used to provide compensation above the cap to hire new employees or to increase the salaries of current employees who are under the cap—thereby increasing state personal income tax revenue from these employees. Such hospital could also reallocate the funds to increase the amount of charity care provided to uninsured individuals. To the extent this reduces the amount of charity care necessary at public hospitals, this would reduce costs for state and local governments, again potentially offsetting any revenue decrease resulting from the measure.

Summary of Fiscal Effect

This measure would have the following significant fiscal effect:

- State administrative costs in the low millions of dollars annually to enforce the measure, with authority to recover costs through fees assessed on specified hospitals.

Sincerely,

Mac Taylor
Legislative Analyst

Michael Cohen
Director of Finance