SUBCOMMITTEE NO. 5

CORRECTIONS, PUBLIC SAFETY, THE JUDICIARY, LABOR and PUBLIC EMPLOYEES

Public Safety and the Judiciary

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Trial Court Funding

BACKGROUND:

Chapter 850, Statutes of 1997, enacted the Lockyer-Isenberg Trial Court Funding Act of 1997 to provide a stable and consistent funding source for the trial courts. Beginning in 1997-98, consolidation of the costs of operation of the trial courts was implemented at the state level, with the exception of facility, revenue collection, and local judicial benefit costs. This implementation capped the counties' general purpose revenue contributions to trial court costs at a revised 1994-95 level. The county contributions become part of the Trial Court Trust Fund, which supports all trial court operations. Fine and penalty revenue collected by each county is retained or distributed in accordance with statute.

Chapter 1082, Statutes of 2002, enacted the Trial Court Facilities Act of 2002, which provided a process for the responsibility for court facilities to be transferred from the counties to the state by July 1, 2007. This Chapter also established several new revenue sources, which went into effect on January 1, 2003. These revenues are deposited into the State Court Facilities Construction Fund (SCFCF) for the purpose of funding the construction and maintenance of court facilities throughout the state. As facilities transfer to the state, counties will also contribute revenues for operation and maintenance of court facilities based upon historical expenditures.

In enacting these changes, the Legislature sought to create a trial court system that was more uniform in terms of standards, procedures, and performance. The Legislature also wanted to maintain a more efficient trial court system through the implementation of cost management and control systems.

The Judicial Council is the policymaking body of the California courts, the largest court system in the nation. Under the leadership of the Chief Justice and in accordance with the California Constitution, the council is responsible for ensuring the consistent, independent, impartial, and accessible administration of justice. The Administrative Office of the Courts (AOC) implements the council's policies.

Currently, the state maintains 58 trial court systems, each having jurisdiction over a single county. These courts have trial jurisdiction over all criminal cases (including felonies, misdemeanors, and traffic matters). They also have jurisdiction over all civil cases (including family law, probate, juvenile, and general civil matters). In 2009–10, more than ten million cases were filed in trial courts throughout the state.

Major Trial Court Realignment Legislation

Legislation	Description
Lockyer–Isenberg Trial Court Funding Act of 1997. Chapter 850, Statues of 1997 (AB 233, Escutia and Pringle)	Transferred financial responsibility for trial courts (above a fixed county share) from the counties to the state.

Legislation	Description
Trial Court Employment Protection and Governance Act. Chapter 1010, Statutes of 2000 (SB 2140, Burton)	Classified most individuals working in the trial courts as court employees.
Trial Court Facilities Act of 2002. Chapter 1082,Statutes of 2002 (SB 1732, Escutia)	Initiated the transfer of ownership and responsibility of trial court facilities from the counties to the state.

GOVERNOR'S PROPOSAL:

The Governor proposes $50 million for the Trial Court Trust Fund from civil court fee increases. These funds would be available to offset the ongoing impact of reductions in funding for trial court operations contained in previous budget acts. Additionally, the budget includes a provision that would grant the Judicial Council the authority to allocate the continuing budget reductions across the branch, and to redirect funding from other court fund sources, as the Judicial Council deems appropriate.

The following shows total trial court funding assumed in the budget since 2008-09. More offsets than reductions in some years are due to previous reductions being one-time in nature.

(dollars in millions)

2010-11	2011-12	2012-13
$3,218	$2,667	$2,819

The Governor proposes a trigger reduction of $125 million if the Governor's tax proposal is not approved in November. While the Branch would determine how to implement this reduction, it is the equivalent of court closures equal to three days per month.

ISSUES TO CONSIDER:

Recent reductions in trail court funding. Although trial courts have experienced reductions in General Fund support in the past several years, these reductions have been largely offset by fund shifts and additional revenue from court-related fee increases. As a result, although cumulative reductions currently stand at $605.8 million, the total level of funding for trial courts has remained relatively flat in recent years. For instance, in 2010-11, trial courts actually received an increase in funding as compared to 2009-10 and the actual funding reduction allocated to trial courts for 2011-12 was $138.3 million.

Following is a summary of reductions and offsets to trial court funding since 2008-09.

(dollars in millions)

Trial Court Reductions	2008-09	2009-10	2010-11	2011-12
Unallocated Reduction	$92.2	$268.6	$55	$320
One-time Reduction		(100)	(30)	
Total	**$92.2**	**$268.6**	**$55**	**$320**
Offsets	**2008-09**	**2009-10**	**2010-11**	**2011-12**
Use of Local Reserves	$92.2	$71	$25	$0
Transfer From other Funds		130	130	233.0
Fee Increases		46.7	113.2	107.1
Use of Fund Reserve		3	36	69.4
Total	**$92.2**	**$250.7**	**$304.2**	**$409.5**

Although funding reductions have been largely offset in the past, many of the sources used for these offsets have been exhausted. Additionally, although some funding for employee benefit cost increases has been provided, trial courts have not received an inflation or cost-of-living adjustment since 2008-09 ($70.1 million Consumer Price Index adjustment), which increases the pressure on trial courts to provide a sustained level of service.

Previous reductions continue to impact trial court services. Under Government Code (GC) section 68106, courts must provide written notice to the public and to the Judicial Council at least 60 days before instituting any plan to reduce costs by designating limited services days. The council, in turn, must post all such notices on its internet site within 15 days of receipt. Since GC Section 68106 became operative on October 19, 2010, the Judicial Council has received the following notices from 24 courts:

County	Notice
Alameda	Clerk office hours reduced an hour and a half.
Butte	Closed Paradise Courthouse, which only offered counter services.
Calaveras	Clerk office hours reduced an hour and 15 minutes.
Fresno	Due to staffing shortages, closed four courts during parts of the last two weeks of December 2011.
Humboldt	Clerk office hours reduced by two hours.
Kings	Changed Avenal courtroom proceedings schedule from every Wednesday (1/2 days) to every other

County	Notice
	Wednesday (full-days). Closed three courthouses from December 27, 2011 through December 30, 2011.
Lake	Will close clerk's office and all courtrooms for a total of 13 days in the current fiscal year, which are unpaid furlough days for all employees.
Lassen	Clerk office hours reduced by two hours.
Mendocino	Changed calendar schedule for Covelo and Point Area Courts from one time per month to one time every other month. Clerk office hours reduced by one hour.
Merced	Clerk office hours reduced by one hour. Implemented limited operation days for seven days in November and December 2011, which included closure of all clerk's offices and all but two courtrooms.
Nevada	Reduced clerk's office and courthouse hours by two hours each Friday.
Placer	Will Close clerk's office and courtrooms for 12 days during the current fiscal year. On one of these days, a single courtroom will remain open to handle certain criminal/juvenile matters.
San Bernardino	Closing the Big Bear Courthouse and Needles Courthouses for two day per month.
San Francisco	Closed 14 civil courtrooms.
San Joaquin	Closed the Tracy Court Branch and one courtroom and one clerk's office at the Lodi Court branch.
San Luis Obispo	Closed the Grove Beach Courthouse.
San Mateo	Closed the Northern Branch satellite office, which handled certain family law, probate, and civil filings. Closed Courtroom G at the San Mateo Court Central Branch on Tuesdays and Thursdays. Revised traffic arraignment calendar process. Clerk office hours reduced by one hour.
Santa Clara	Clerk office hours at the Santa Clara Courthouse reduced by three hours Monday through Thursday.
Santa Cruz	Implementing four limited service days during the current fiscal year.
Shasta	Clerk office hours at the Burney Branch location reduced by two hours.
Siskiyou	Discontinued one-day per month court sessions in Tulelake.
Tehama	Clerk's office hours reduced by one hour Monday

County	Notice
	through Thursday.
Ventura	Clerk's office hours reduced by one hour. Limited court closures on six days in November and December 2011. Reassigned its two East County Civil Law Judges and related clerk services at the Simi Valley location, except for unlawful detainers, family law and small claims.
Yolo	Clerk office hours reduced by two hours. Reduced calendar from December 19, 2011 through December 30, 2011.

In addition to the notices listed above, efforts to reduce trial court expenditures have led to staffing reductions, including.

- San Joaquin Superior Court, which recently laid off 42 employees.
- San Francisco Superior Court, which recently laid off 75 employees.
- Los Angeles Superior Court, which previously laid off 329 employees.

Many one-time offsets have been exhausted. As mentioned previously, reductions in funding for trial courts have largely been offset by fund shifts or transfers, use of local funding reserves, fee increases, and court closures. Other than fee increases, many of these offsets have been one-time in nature and may no longer be feasible options to mitigate the impact of previous reductions in trial court funding.

The AOC has indicated that trial courts can operationalize a significant amount of the funding reductions contained in prior budgets. However, the AOC also indicates that, without some level of restoration, trial court services will be further impacted.

Judicial Branch proposed solutions for trial court funding. The AOC has proposed that the following solution be considered as a package of components that can provide ongoing funding stability for trial courts.

- **Establish a New Baseline Budget That Reflects an Appropriate Level of Ongoing Funding Based on Cumulative Reductions.** Trial courts will absorb approximately $350 million as operationalized reductions while recognizing that courts may be unable to provide full access to justice. This is an attempt to more accurately reflect the budget after the successive years of one-time borrowing solutions.

- **General Fund Restoration.** Part of the ongoing solution would include a restoration of $150 million. This restoration is proposed to be made over the next three fiscal years: $100 million in 2012-13, another $25 million in 2013-14, and a further $25 million in 2014-15.

- **Additional and/or Increases in Various Civil Fees.** As done in past years, the judicial branch will work with the other branches of government and judicial branch stakeholders, including the State Bar, to develop a range of user-fees. As mentioned above, the proposed budget includes $50 million in new fee revenue for the trial court trust fund.

- **Transfer and Redirections from other Court Funds.** Part of the solution would include a redirection from other funds, after consultation and negotiation with branch stakeholders. The court's goal is to achieve a consensus on redirections of $50 million.
- **Improved Efficiencies in Court Operations and Changes in Unnecessary Statutory and Reporting Requirements.** The Judicial Branch would identify areas in which courts can become more efficient without threatening the administration of justice and make changes in those areas.
- **Trial Court Fund Balances.** Part of the solution would include the trial courts using $100 million of the fund balances in 2012-13, $75 million in 2013-14, and $50 million in 2014-15.

Court construction funding. The Judicial Branch has two primary court construction funds, the SCFCF, which receives approximately $130 million from fees and penalty assessments to support trial court construction projects, and the Immediate and Critical Needs Account (ICNA), which receives approximately $321 million from various civil and criminal fines and fees to support 41 trial court construction projects that were deemed to be immediate and critical by the Judicial Council. In the current year, the following actions were taken related to these two funds:

- Transferred $310.3 million from the ICNA to the GF.
- Loaned $350 million from the SCFCF to the GF, to be repaid with interest.
- Loaned $90 million from the ICNA to the GF, to be repaid with interest.
- Provided authority to the AOC to allow for redirection of $130 million from the SCFCF and ICNA to offset the reduction to trial court funding.

The AOC submitted a revised court construction funding plan to the Judicial Council in December that results in minimal project delays and the cancelation of only two, one-courtroom projects (Alpine and Sierra). The Legislature should receive a proposal this spring that reflects this funding plan.

Due to delays related to the acquisition of properties, the construction program has been able to proceed with minimal impact to projects. However, in 2012–13 and beyond, the redirections and loans may cause delays to the project schedules

California Court Case Management System (CCMS). As part of an effort to address technology problems facing the many case management systems used by trial courts, the AOC, at the direction of the Judicial Council in 2003, undertook the development of a single court case management system. The most recent version of the statewide case management project, CCMS, covers all court case types. According to a February 2011 report by the State Auditor, AOC records show that in 2015-16, the year in which the AOC estimated at the time of the report that CCMS will be deployed statewide, the full cost of the project is likely to reach nearly $1.9 billion (not including costs that superior courts will incur to implement CCMS). To date, over $500 million has been spent on CCMS. In addition to total cost, other concerns highlighted by the audit include: 1) inadequate planning, 2) failure to adequately structure the development vendor's contract, 3) failure to develop accurate cost estimates, and 4) the AOC's need to gain better support from the superior courts for the project.

To date, the Legislature has not received a comprehensive CCMS deployment and funding plan and concerns have been raised that funding for CCMS should be directed to trial court operations. However, recently the AOC retained a new firm to assist in developing a deployment plan, which will provide baseline deployment cost estimates for three early adopter courts, provide a phase two deployment plan for up to ten additional courts, cost estimates for their deployment, and an analysis of the potential benefits and opportunities of the deployments. The AOC indicates that this report will be made available to the Legislature this spring.

Previous trial court closure. The 2009–10 budget authorized the Judicial Council to provide that the courts be closed for the transaction of judicial business for one day per month. On July 29, 2009, the Judicial Council designated the third Wednesday of the month from September 2009 through June 2010 as a uniform statewide court closure day. The council directed that on that day, all superior courts, Courts of Appeal, and the Supreme Court would be closed.

The impact of court closures varied considerably from court to court. A few courts reported that there was no discernible impact or only a minimal impact. But most courts reported that there was a noticeable impact on court operations and court users from closure of the courts. Workload did not go away simply because the court was closed one day a month. Just as on existing court holidays, that workload shifted to other days. The Legislature may consider asking the AOC to provide greater detail on the impacts of the previous one-day closure and expected impacts of closing trial courts for three days per month.

Proposed legislation would impact trial court funding. AB 1208 (Calderon) addresses judicial branch governance, primarily by reducing the role of the Judicial Council in determining the allocation of funds to trial courts. By doing so, this bill moves away from the recent realignment of trial courts from locals to the state.

The main support for AB 1208 comes from the Alliance of California Judges, which consists of judges who have voiced opposition to many Judicial Council and AOC initiatives and the "erosion" of the power of trial courts in California since the passage of the Lockyer-Isenberg Trial Court Funding Act in 1997.

The Judicial Council opposes AB 1208, arguing that the bill would remove from the Judicial Council its responsibility and authority to allocate funds to trial courts in a manner that supports implementation of statewide policies and initiatives. The council also has expressed concern that AB 1208 removes the council’s role of ensuring the stability of trial court operations and providing management or oversight over trial court budgets and that it is an inappropriate intrusion into the fundamental governance of the judicial branch.

Division of Juvenile Justice Realignment

BACKGROUND:

The Division of Juvenile Justice (DJJ), originally known as the California Youth Authority (CYA), was created by statute in 1941 and began operating in 1943, providing training and parole supervision for juvenile and young adult offenders.

In a reorganization of the California corrections agencies in 2005, the CYA became the DJJ within the Department of Corrections and Rehabilitation. Currently, the DJJ receives its youthful offender population from both juvenile and adult court referrals.

The DJJ carries out its responsibilities through three divisions: the Division of Juvenile Facilities, the Division of Juvenile Programs, and the Division of Juvenile Parole Operations. The Juvenile Parole Board, an administrative body separate from DJJ, determines a youth's parole readiness.

Youths committed directly to the DJJ do not receive determinate sentences. A youth's length of stay is determined by the severity of the committing offense and their progress toward parole readiness; however, the DJJ is authorized to house youths until age 21 or 25, depending upon their commitment offense.

The DJJ also provides housing for youths under the age of 18 who have been sentenced to state prison. Youths sentenced to state prison may remain at DJJ until age 18, or if the youth can complete his or her sentence prior to age 21, the DJJ may house him or her until released to parole.

The vast majority of youthful offenders are now directed to county programs, enabling direct access and closer proximity to their homes, families, social programs and services, and other support systems. Those youths directed to the DJJ have been convicted of the most serious and violent crimes and/or are most in need of the specialized treatment services necessary for their success. DJJ youth represent approximately one percent of the 225,000 youth arrests each year.

GOVERNOR'S PROPOSAL:

The Governor proposes that DJJ will stop intake of new juvenile offenders effective January 1, 2013, eventually transferring the responsibility for managing all youthful offenders to local jurisdictions. The Governor's proposal includes $10 million in 2011-12 to support local governments in planning for the realignment of the remaining DJJ population. Absent realignment, DJJ's proposed budget is $199 million for 2012-13.

The Governor has delayed charging counties $125,000 per juvenile offenders committed to DJJ, pursuant to the current-year trigger.

ISSUES TO CONSIDER:

Previous efforts to realign the state's juvenile justice responsibilities to local jurisdictions have been successful. Since reaching a high of 10,122 in 1996, the number of youths committed to the DJJ by juvenile and superior courts has steadily declined. The budget reports that DJJ's average daily population will be 1,149 in 2012-13. This reduction in population has led to the closing of the majority of DJJ facilities. Today the DJJ operates three facilities (two in Stockton and one in Ventura) and one fire camp.

The drastic decline in population began in the mid to late 1990s and continued through the last decade due to the following factors:

- Counties received increased federal funding to build additional treatment facilities.
- *Chapter 6, Statutes of 1996, (SB 681, Hurtt),* enacted changes in fees counties paid to house youths in DJJ facilities based upon the classification of a youths commitment offense.
- *Chapter 175, Statutes of 2007, (SB 81, Committee on Budget and Fiscal Review) and Chapter 257, Statutes of 2007, (AB 191, Committee on Budget),* restricted juvenile court commitments to cases that were violent offenses as specified in Section 707(b) of the Welfare and Institutions Code, or sex offenses as specified in Section 290 of the Penal Code.
- *Chapter 729, Statutes of 2010, (AB 1628, Blumenfield),* transferred youth parole responsibilities to county probation, eliminating DJJ parole by June 30, 2014.

Along with the increased responsibility, the state has provided locals with resources to house and treat juvenile offenders, including the following sources that are all ongoing, except the local jail construction funds:

(dollars in millions)

Source	Amount
Juvenile Justice Crime Prevention Grants	$107.1
Juvenile Probation Funding	151.8
Juvenile Camp Funding	29.4
SB 81/AB 191 and AB 1628 Realignment	104.1
Local Jail Construction	$300

A recent report by the Center on Juvenile and Criminal Justice notes that several counties, such as San Bernardino, Napa, Santa Clara, Alameda, San Francisco and Santa Cruz, have implemented innovative local practices for rehabilitation of serious youth offenders. The report further notes that some of these counties are seeing reductions in recidivism rates. Additionally,

according to the California Department of Justice's most recent report on crime statistics, juvenile arrest rates have decreased from 2005-2010.

What is an appropriate level of state juvenile justice responsibility. If the Governor's proposal to realign responsibility for all juvenile offenders in California is adopted, California may be the only state without state sanctions for juvenile offenders. DJJ's current population, although small in numbers, is comprised of our state's highest risk juvenile offender population. Representatives of probation officers have noted that they do not have the capacity to treat many of the youth that are sent to DJJ because of the severity of their treatment need (many have acute mental health or sexual behavioral symptoms) nor do they want to house these youth with the population that is currently kept locally due to management concerns.

On the other hand, some have questioned the state's ability to house and provide adequate services for juvenile offenders. DJJ is currently under a consent decree as a result of the *Farrell v. Cate* lawsuit, which was initiated with a complaint surrounding conditions in the juvenile justice system that was filed in state court in January 2003. Six remedial plans were developed and have guided improvements (a Special Master in the *Farrell* case has filed periodic reports detailing the changes in conditions). However, there is continuing debate as to whether the DJJ can ever reach full *Farrell* compliance.

Counties are currently implementing changes to absorb the impact of the 2011 public safety realignment. Per the 2011 Public Safety Realignment, which requires that certain low-level felony offenders serve their time locally and shifts the majority of the state's parole population to local jurisdictions, counties are currently dealing with a significant increase in public safety responsibilities. Probation departments are in the process of creating and implementing new supervision strategies and adjusting workforces accordingly. Given this huge shift in responsibility that local probation departments are currently dealing with, the Legislature must consider impacts that realigning the state's juvenile population at this time may have on the implementation of the 2011 public safety realignment.

Potential hurdles. Stakeholders and the Administration have acknowledged issues related to realigning DJJ's population, including statutory issues, that remain unresolved. These include; 1) age of jurisdiction, counties can only retain wards up to the age of 21, while DJJ retains wards to the age of 25, 2) court commitment changes, establishing a process for changes in commitment status, 3) the potential increase in Direct Files of juveniles in adult court, and 4) potential sight and sound barriers required for inmates under the age of 18, if they are housed in adult institutions. Until resolution to many of these issues becomes clearer, it may be premature to provide locals with $10 million in planning funding, as the budget proposes.

CDCR Realignment Savings

BACKGROUND:

Last year, Governor Brown signed AB 109 and AB 117 (known as public safety realignment), historic legislation that will enable California to close the revolving door of low-level inmates cycling in and out of state prisons. It is the cornerstone of California's solution for reducing the number of inmates in the state's 33 prison to 137.5 percent of design capacity by June 27, 2013, as ordered by a Three-Judge Court and affirmed by the United States Supreme Court. In a May 23, 2011 decision, the United States Supreme Court affirmed the judgment of a three-judge panel convened pursuant to the Prison Litigation Reform Act of 1995 (18 U. S. C. §3626) ordering California to reduce its prison population to no more than 137.5 percent of its design capacity within two years.

Key Features of Public Safety Realignment

Felon Incarceration	Post-Release Supervision	Parole and PRCS Revocations
Restructured felon penalty by making specified non-violent, non-serious, non-sex offenses subject to local punishment	Created Post Release Community Supervision (PRCS) for certain offenders to be supervised locally upon release from prison	Parole revocation terms are served locally and, by July 1, 2013 both parole and PRCS revocations will be adjudicated by the courts

Under AB 109 and AB 117, all felons convicted of current or prior serious or violent offenses, sex offenses, and sex offenses against children will go to state prison. Additionally, there are nearly 60 additional crimes that are not defined in the Penal Code as serious or violent offenses but remain offenses that would be served in state prison rather than in local custody.

On December 28, 2011, the population of California's 33 prisons was 132,887, or 166.8 percent of design capacity, meeting the first population target of the court order's timeline. Under the Three-Judge Court's prisoner-reduction order, the inmate population in California's 33 prisons must be no more than:

Court Deadlines	Design Capacity Limit	Population Limit	Population Reduction
December 27, 2011	167%	133,000	11,000
June 27, 2012	155%	123,000	10,000
December 27, 2012	147%	117,000	6,000
June 27, 2013	137.5%	110,000	7,000
Two-Year Total			**34,000**

Design capacity is the number of inmates a prison can house based on one inmate per cell, single-level bunks in dormitories, and no beds in places not designed for housing. Current design capacity in CDCR's 33 institutions is 79,650.

GOVERNOR'S PROPOSAL:

The Governor assumes $1.1 billion in savings and reductions of approximately 4,890 positions in CDCR's budget to account for changes in adult inmate and parole populations that are primarily due to public safety realignment. Below is a summary of total CDCR spending followed by a summary of budgeted realignment savings. The total General Fund decrease from 2010-11 to 2012-13 is approximately $817 million.

(dollars in millions) **CDCR Funding**

Funding	2010-11	2011-12	2012-13
General Fund	$9,481.8	$8,980.8	$8,664.8
General Fund, Prop 98	24.5	23.6	21.2
Corrections Training Fund	21.6	22.2	-
Lottery Education Fund	.3	.1	.1
Federal Trust Fund	11.2	28.3	4.6
Inmate Welfare Fund	50.4	65.0	65.3
Special Deposit Fund	.9	2.4	2.3
Reimbursements	106.2	103.3	130.1
Local Safety and Protection Account, Trans Tax Fund	24.4	-	-
Community Incentive Fund	-	-.6	-.6
Total	**$9,721.3**	**$9,252.1**	**$8,887.8**

(dollars in millions) **CDCR Realignment Savings**

Program	2011-12	2012-13
Administration	$-	-$19.2
Institutions	-167.8	-413.0
Parole	-99.3	-220.5
Community Based Programs	-27.1	-138.3
Board of Parole Hearings	-	-16.9
Adult Ed, Voc., Substance Abuse Programs	-6.4	-18.5
Inmate Health Care	-47.2	-111.0
Contract Facilities	-105.5	-138.7
Total	**-$453.3**	**-$1,076.1**

The budget also proposes a reassessment of prison construction needs, recognizing that realignment fundamentally alters the state's future facility needs as funded under AB 900 (Solorio, Statutes of 2007). The primary purpose for the infill program may no longer be present, since the state will no longer operate any non-traditional bed capacity. The budget includes a reduction of $44.5 million to reflect the cancellation of the Estrella infill project. Additionally, the budget reflects that the state is not currently proceeding with the construction and conversion of the DeWitt youth facility to an adult facility. It is anticipated that the state will avoid approximately $250 million in annual debt service costs as a result of the revised construction plan. The Budget also assumes savings of $125 million related to infrastructure projects authorized by AB 900 that are not needed as a result of realignment.

ISSUES TO CONSIDER:

The budget does not include detail on how the $1.1 billion in savings will be operationalized. CDCR has made strides in implementing changes that are reducing costs as realignment impacts the prison population. For instance, CDCR terminated all but one of its contracts with community correctional facilities across the state; terminated or did not renew contracts for inmate services or programs that are not designed for the department's remaining population; and announced its plans to convert Valley State Prison for Women in Chowchilla to a facility that will house low- to medium-security adult male inmates. However, these actions do not address the significant cost reductions that must be achieved within the operations of the department's 33 prisons. During budget hearings, the Legislature should ensure that CDCR presents a plan that details how housing units and staffing will be adjusted in accordance with the proposed budget.

New prison construction will offset savings from realignment. Approximately $6.1 billion was authorized under AB 900 to construct prison beds (infill, re-entry, and health care). The Receiver, appointed to oversee prison medical care, is currently building a 1,722 bed prison in Stockton that will cost just under $1 billion to build and $190-230 million annually to operate

once complete. The Receiver has also maintained that the state must keep its commitment to other construction projects.

Although constructing new prison beds would add capacity, it would not help California meet the three-judge panel timeline and. In its last analysis of AB 900, the LAO estimated that the combined costs of infill and re-entry projects would add approximately $1.3 billion annually to CDCR's budget.

Realignment stops growth trend in state corrections. State spending on corrections rose from $604.2 million in 1980-81 to $9.6 billion in 2010-11, a nearly 1,500 percent increase that significantly outpaced the growth of total state General Fund spending during the same period. As a result, state spending on corrections more than tripled as a share of General Fund expenditures, rising from 2.9 percent in 1980-81 to 10.5 percent in 2010-11.

The increase in state corrections spending is related to the significant growth of the inmate and parolee population that occurred in the 1980s and 1990s and to the rising cost of corrections as measured by spending per inmate or parolee. The increase in the offender population is primarily attributable to significant changes in sentencing laws and to more aggressive local law enforcement and prosecution. Higher per inmate or parolee expenditures primarily reflect the dramatic increase in inmate health care spending as well as the rising cost of prison security and adult parole.

Notwithstanding the Supreme Court order to reduce the inmate population due to the recognition of overcrowding as the primary obstacle to a constitutional level of care, realignment is also the only significant policy change that will lead to a substantial reduction in correction's spending at the state level. In times of fiscal austerity, there are very few options to reduce prison spending, which impacts the level of cuts that other state programs must endure. Achieving CDCR's realignment savings is critical, and so too is the cost avoidance realignment will provide for the state going forward, which will allow for greater flexibility in supporting other critical priorities.

Board of State and Community Corrections

BACKGROUND:

Originally, the Board of Corrections (BOC) was established in 1944 as part of the state prison system. Effective July 1, 2005, as part of the corrections agency consolidation, the Corrections Standards Authority (CSA) was created within CDCR by bringing together the BOC and the Correctional Peace Officers Standards and Training (CPOST) commission. The reorganization consolidated the duties and functions of the BOC and CPOST and entrusted the CSA with new responsibilities.

The CSA works in partnership with city and county officials to develop and maintain standards for the construction and operation of local jails and juvenile detention facilities and for the employment and training of local corrections and probation personnel. The CSA also inspects local adult and juvenile detention facilities, administers funding programs for local facility construction, administers grant programs that address crime and delinquency, and conducts special studies relative to the public safety of California's communities.

The CSA currently operates using a four divisional structure:

- **Facilities Standards and Operations Division.** The Facilities Standards and Operations Division works in collaboration with local corrections agencies to maintain and enhance the safety, security, and efficiency of local jails and juvenile detention facilities.
- **Corrections Planning and Programs Division.** The Corrections Planning and Programs Division plans, develops, and administers programs in collaboration with local and State corrections agencies to enhance the effectiveness of correctional systems and improve public safety.
- **Standards and Training for Corrections Division.** The Standards and Training for Corrections Division works in collaboration with State and local corrections and public/private training providers in developing and administering programs designed to ensure the competency of State and local corrections professionals.
- **County Facilities Construction Division.** The County Facilities Construction Division works in collaboration with State and local government agencies in administering funding for county detention facility construction projects, for the purpose of enhancing public safety and conditions of confinement.

Legislation associated with the 2011 Budget Act abolished the CSA and established the new Board of State and Community Corrections (Board) as an independent entity, effective July 1, 2012. The Board will absorb the previous functions of the CSA as well as other public safety programs previously administered by the California Emergency Management Agency (CalEMA). Specific statutory changes include:

- Abolish the CSA within CDCR and established the Board as an independent entity.
- Transfer the powers and duties of the CSA to the Board.
- Transfer certain powers and duties that currently reside with CalEMA to the Board.
- Eliminate the California Council on Criminal Justice and assigned its powers and duties to the Board.
- Reestablish CPOST within CDCR.

The Board will provide statewide leadership, coordination, and technical assistance to promote effective state and local efforts and partnerships in California's adult and juvenile criminal justice system. Particularly important in the next several years will be coordinating with and assisting local governments as they implement the realignment of many adult offenders to local government jurisdictions that began in 2011. The Board will guide statewide public safety policies and ensure that all available resources are maximized and directed to programs that are proven to reduce crime and recidivism among all offenders.

The new Board will be an entity independent from CDCR. The Board will continue to be chaired by the Secretary of CDCR, and its vice-chair will be a local law enforcement representative. The Board will have 12 members, streamlined from both its immediate predecessor (CSA), with 19 members, and its former predecessor (BOC), which had 15 members. Members will reflect state, local, judicial, and public stakeholders.

GOVERNOR'S PROPOSAL:

The Budget proposes $109.2 million ($16.9 million General Fund and $92.2 million other funds) for the state operations and local assistance programs included under the Board. The funding is comprised of resources transferred from the CSA and CalEMA and will allow the Board to operate as an independent entity. The following chart summarizes the proposed funding and program structure of the Board, including resources transferred from CDCR and Cal EMA:

(dollars in millions)

	Funding	Positions
Program 10 - Board Administration and Program Support	$1.99	19.0
Program 15 - Corrections Planning and Grant Programs	$81.26	23.5
Program 20 - Local Facilities Standards and Operations	$3.81	20.0
Program 25 - Standards and Training for Local Corrections	$22.19	13.0
Board Total	**$109.16**	**75.5**
From CDCR	**-$63,191**	**-68.5**
From CalEMA	**-$45,970**	**-8.5**
Net Total of the Establishment of the Board	**$0**	**-1.5**

Beside the core CSA functions, outlined above, the proposal includes $253,000 from CDCR for administrative functions and the transfer of $8.9 million from CDCR to assist counties with the implementation of the 2011 public safety realignment. The Board is to administer these funds, in consultation with the Department of Finance. Of the $8.9 million, $7.9 million is to be distributed to counties for the Community Corrections Partnership to develop realignment implementation plans and the remaining $1 million is to provide state-wide training to counties.

Programs that will transfer from CalEMA include:

- **Edward Byrne Justice Assistance Grant (JAG) Program** - The U.S. Congress established the JAG program in the 2005 Omnibus Appropriations package. California's JAG program recipients include local criminal justice agencies, which utilize the grant to address apprehension, prosecution, adjudication, detention, and rehabilitation of offenders who violate state and local laws. California's JAG program also funds the California Counter Drug Procurement Program.

- **Residential Substance Abuse Treatment (RSAT) Program** - The RSAT Program is designed to assist state and local government agencies in developing and implementing substance abuse treatment programs in correctional and detention facilities and to provide community-based aftercare services for offenders.

- **California Gang Reduction, Intervention, and Prevention (CalGRIP) Initiative** - The CalGRIP Initiative provides Restitution Fund grants to cities using a local collaborative effort for anti-gang activities.

  Lastly, CSA and Cal EMA provided grants directly to local public safety agencies, including: Citizen's Option for Public Safety (COPS); Juvenile Justice Crime Prevention Act Grants; Booking Fees, Small and Rural Sheriffs Grants; Juvenile Probation Funding; California Multi-Jurisdictional Methamphetamine Enforcement Team; California Gang Violence Suppression Program; Multi-Agency Enforcement Consortium; Rural Crime Prevention; Sexual Assault Felony Enforcement; and the High Technology Theft Apprehension and Prosecution Program. Funding for these programs was realigned to locals as part of the 2011 public safety realignment. However, if it is determined that state level administration requirements remain for any of these programs, the Board would fulfill those responsibilities.

ISSUES TO CONSIDER:

The Board will be critical to the implementation and success of the 2011 public safety realignment. One of the key drivers in establishing the Board was the need for a state/local body that could serve as the backbone of California's public safety continuum. To facilitate local success, California needs to strategically coordinate support, foster local leadership, target resources and provide technical assistance. Per statute, the Board will be charged with "providing statewide leadership, coordination, and technical assistance to promote effective state and local efforts and partnerships in California's adult and juvenile criminal justice system, including addressing gang problems. This mission shall reflect the principle of aligning fiscal policy and correctional practices, including, but not limited to prevention, intervention, suppression, supervision, and incapacitation, to promote a justice investment strategy that fits

each county and is consistent with the integrated statewide goal of improved public safety through cost-effective, promising, and evidence-based strategies for managing criminal justice populations."

The Board also will have the duty to "collect and maintain available information and data about state and community correctional policies, practices, capacities, and needs, including, but not limited to, prevention, intervention, suppression, supervision, and incapacitation, as they relate to both adult corrections, juvenile justice, and gang problems. The Board shall seek to collect and make publicly available up-to-date data and information reflecting the impact of state and community correctional, juvenile justice, and gang-related policies and practices enacted in the state, as well as information and data concerning promising and evidence-based practices from other jurisdictions."

Within these responsibilities, the Board will play a key role in collecting, maintaining, and reporting data regarding the 2011 public safety realignment. Such data will be critical in understanding how resources should be allocated and how program success is ultimately measured.

It is worth noting that there is significant interest in researching and reporting on aspects of the 2011 public safety realignment from within academic and private foundation communities. One project of note, The Partnership for Community Excellence (The Partnership) established by California Forward, seeks to develop a "hub" to coordinate efforts to assist local governments in implementing public safety realignment. The Partnership notes that the state has not provided any direction or assistance to counties in developing integrated strategies to reduce costs and improve outcomes. This effort highlights the urgency for the Board to take the reins in ensuring that California has an efficient and effective approach to public safety in a time of such momentous change.

Public Employee Retirement

BACKGROUND:

The state offers comprehensive post-employment benefits to its employees, typically comprised of monthly pension payments, as well as health, dental, or other benefits that are funded in part by their former employer. The health, dental, and other benefits are called "other post-employment benefits" (OPEBs). Unlike the pension benefit, the state has not typically “pre-funded” its retiree health liabilities. OPEB costs are instead paid on a “pay-as-you-go” basis and generally there are no investment returns to offset the employer and retiree shares of health costs.

Employee and Employer Pension Contributions

State employees are enrolled in defined benefit pension plans, which provide employees with a specified benefit, generally based on their salary levels near the end of their career, their number of years of service, and the type of job they had while in public employment. The pension benefit is funded from public employer and public employee contributions, as well as investment earnings generated from those contributions. Generally speaking, the state and its employees combined pay pension “normal costs” each year, which are the funds that need to be set aside and invested now to cover all future costs of benefits that employees earn in that year.

As the employer, the state makes annual payments to: (1) pension programs for state and CSU employees, (2) teachers’ pensions, (3) state and CSU retiree health benefit programs, and (4) pension programs for judges. The teachers’ pension program is administered by the California State Teachers’ Retirement System (CalSTRS), and the other three programs are administered by the California Public Employees’ Retirement System (CalPERS). The state also provides funding to UC for retiree health benefit programs.

One clear distinction between CalPERS and CalSTRS is important to understand. CalPERS sets the state employer contribution rate each year, and that rate can rise or fall depending on investment returns and the funded status of the CalPERS plan. CalSTRS, on the other hand, has both the employer and employee rate set in statute. CalSTRS has no legal authority to raise the employer contribution rate in the manner that CalPERS can.

2010 and 2011 Pension Reforms Adopted for State Employees

State employees generally are obligated to contribute only a fixed amount, as a percentage of their pay each month, to these pension plans. In 2010 and 2011, the state collectively bargained and reached agreement with its employees on substantive pension reform. These reforms rolled back pension benefits for new hires to levels in place in the 1970s and, for both current and new employees, increased most employee pension contributions by two to five percent dependent on bargaining unit. In sum and through 2013-14, these increased employee contributions will reduce the state’s required employer pension contribution by $600 million plus General Fund. However, the *net* savings to the state is substantially less.

Employee pension contributions are negotiable; however, as the LAO has reported, there are strict legal protections that limit government's flexibility to impose increased employee contributions. In the case of the 2010 and 2011 pension reforms, negotiations concerning the pension contribution increases also resulted in delayed implementation (by roughly 12 months) of a top step salary increase equivalent to the increased employee pension contribution (two to five percent, dependent on bargaining unit). As noted by the LAO, these salary increases overtime will tend to erode savings from increased employee pension contributions.

Unfunded Liabilities

Unfunded liabilities are the additional amount that would need to be deposited today and invested over time in order to pay all future benefits earned to date by retirement system members. Unfunded liabilities emerge even when the normal costs are paid each year due to: (1) investment returns that fail to meet the pension system's annual target (such as the near-collapse of world financial markets in 2008); (2) changing "experience study," including that employees are retiring earlier and life expectancy is increasing; and/or (3) increases applied to years already worked ("retroactive" increases). Due to the limitations described above on employee pension contributions, the unfunded liabilities are generally the responsibility of the employer. The budget estimates that the state faces unfunded pension obligations of $45.2 billion and unfunded retiree health obligations of $59.9 billion.

LAO Estimates of General Fund Costs for Retirement Programs (dollars in billions)

	1992-93	1997-98[1]	2002-03	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
CalPERS Retirement Program[2]	$0.48	$1.71	$0.66	$1.86	$1.92	$1.79	$2.00	$2.18	$2.45
CalPERS Retiree Health Program[3]	$0.34	$0.33	$0.65	$1.22	$1.26	$1.30	$1.52	$1.67	$1.87
CalSTRS	$0.69	$0.95	$0.98	$1.62	$1.13	$1.25	$1.26	$1.32	$1.36
Other[4]	$0.03	$0.04	$0.11	$0.15	$0.18	$0.17	$0.16	$0.13	$0.14
Total	**$1.54**	**$3.03**	**$2.40**	**$4.85**	**$4.49**	**$4.51**	**$4.94**	**$5.31**	**$5.82**
Retirement Costs as % of GF	**3.8%**	**5.7%**	**3.1%**	**4.7%**	**4.9%**	**5.2%**	**5.4%**	**6.1%**	**6.3%**

[1]Amount for 1997-98 includes a $1 billion plus state payment related to a major court case involving CalPERS.
[2]CalPERS retirement program costs include state General Fund contributions to CalPERS pensions for state employees, judges, and CSU employees.
[3]CalPERS retiree health program cost listed includes LAO rough estimate of implicit subsidy for retiree health benefits paid as part of state contribution to employees health care costs.
[4]Other includes rough estimate of costs in UC and CSU base budgets for annuitant health and/or dental costs and does not include any amounts for UCRP pension costs.

GOVERNOR'S PROPOSAL:

12-Point Pension Reform Plan. In October 2011, the Governor unveiled a 12-point pension reform plan to put the state on a more sustainable path to providing public retirement benefits. It includes provisions for equal sharing of pension normal costs between employers and employees; places new employees in an as yet undefined "hybrid" risk sharing pension plan; increases retirement ages for new employees; requires three-year final compensation calculations for new employees; calculates benefits based on regular, recurring pay; limits post-retirement employment; requires felons to forfeit their pension benefits; prohibits retroactive pension benefits; prohibits pension holidays; prohibits purchases of air time; changes the makeup of the CalPERS Board of Administration; and, requires new state employees to wait longer to vest for retiree health benefits and bear a larger percentage of the cost attributed to those benefits.

When fully implemented, the Administration estimates that the Governor's 12-point plan will cut roughly in half the cost to taxpayers for providing pension benefits to state employees and will also dramatically reduce the risk for future pension debts. However, at this time no hard data or plan specifics have been offered to assist in substantiating those estimates. The Governor's proposal is currently pending before a legislative Conference Committee on Public Employee Pensions which was convened in fall 2011. The Conference Committee met again on January 25, 2012, and continues its work on pension reform, including consideration of the Governor's proposal as well as numerous other legislative reform proposals.

Budget Proposals. The budget includes $2.4 billion General Fund for the CalPERS retirement program, $1.4 billion General Fund for CalSTRS, and $1.8 billion General Fund for the CalPERS retiree health program.

As part of the Administration's long-term plan for UC and CSU, which is discussed in detail in the higher education section of this report, the budget shifts the following retirement and retired annuitant benefit costs, which are currently budgeted and adjusted annually separately, into UC and CSU's base budgets. The budget states that there will be no further adjustments going forward and instead UC and CSU will factor these costs into their overall fiscal outlook and decision making process:

- $90 million increase for UC base operating costs, which the Administration indicates can be used to address costs related to retirement program contributions.
- $5.2 million increase for UC retired annuitant benefits.
- Decreases CSU's employer contribution to CalPERS by $38.5 million due to lower employer contribution rates. CSU's base budget includes a total of $404 million for the required CalPERS employer contribution.
- $1.1 million increase for CSU retired annuitant benefits.

ISSUES TO CONSIDER:

State Budgetary Savings from Pension Reform Reduce Costs Long-Term. As noted above, in 2010 and 2011, the state collectively bargained and enacted substantive pension reform which, among other things, increased employee contributions (and reduced employer contributions by a like amount). Most state employees are now contributing half, or more, of the annual normal cost of their pension, which is the first point in the Governor's 12-point plan. The LAO has reported that it is unlikely that the Governor's plan would produce much *short-term* budgetary savings for state government; rather, the changes would produce substantial *long-term* savings, potentially in the billions of dollars per year, by reducing the state's vulnerability to increased costs from unfunded liabilities. These savings will grow incrementally over the coming decades as new employees are hired and eventually retire under the lower-tier benefit structure.

State/Local Relationship in the Pension Reform Arena. Under current law, cities, counties, and special districts have significant authority and autonomy to collectively bargain retirement benefits. The Governor's proposal, intended to apply statewide to all public employees, would impose significant limits on local retirement plan components and the division of pension costs between employees and employers. In considering these impacts, the LAO has raised several key questions for the Legislature to consider regarding the conflicts between allowing for local control, the long-term consequences and expense of overly generous pension promises made at the local level, and the ratcheting up of benefits that occurs as local employers compete in certain areas for employees.

What about CalSTRS? As of June 2010, and according to CalSTRS actuaries, CalSTRS' unfunded liability totaled $56 billion (this figure will be updated when the CalSTRS Board adopts the June 30, 2011, valuation in April 2012). This liability is not reflected in the budget estimate of total unfunded pension liabilities of $45.2 billion. As previously noted, unlike CalPERS, employer and employee contributions to CalSTRS are fixed in the Education Code. The contribution levels apply on a generally equal basis to all public school and community college districts and are generally not determined through collective bargaining. While statutory contribution levels cover the normal cost of the plan, the economic meltdown in 2008/2009 left CalSTRS with a significant unfunded liability. Currently, there are no plans in place for any entity to pay for the unfunded liability and ensure CalSTRS' future financial stability. The LAO has noted that the Governor's 12-point plan may reduce costs for future teachers enrolled in CalSTRS but it does not appear to include anything to address the liabilities already accrued, but not funded, for current and past employees. The LAO has reported that addressing the CalSTRS unfunded liability is one of the more difficult long-term financial challenges facing the state.

UC and the University of California Retirement System (UCRP). From 1990 to 2010, UC and its employees enjoyed a two-decade pension funding holiday due to: (1) substantial overfunding of UCRP during the 1980s by the state and UC (and its employees) and (2) very strong investment returns for UCRP during the 1980s and 1990s. The state also benefited from the holiday, since it had contributed to UCRP in prior decades and used the elimination of contributions as a budget solution during the fiscal crisis of the early 1990s. During the contribution holiday, UC continued to add employees and provide additional service credit to existing employees – making it impossible for the holiday to continue forever. The investment market downturn of 2008 caused the already dwindling surplus to fade away and UCRP now has an unfunded liability. In the past several years, UC has reinstituted employee and employer contributions and repeatedly sought additional state funding so it can cover normal costs and retire unfunded liabilities over the next several decades. To date, and despite UC's requests, the Legislature has chosen not to provide additional funding to UC for this purpose. UC projects that total state costs would peak at around $400 million plus.

The LAO has highlighted that these pension costs are real obligations that need to be paid, and it is reasonable for the state to cover the retirement costs of UC's state-funded employees, just as it does for other agencies. One over-arching challenge is that it is not clear what the "state share" should be given that UC also has non-state funded employees (such as through federal funds or patient revenues at the academic medical centers). There are also questions about what legal obligations the Legislature could incur by restarting contributions. Therefore, the LAO has advised that the Legislature proceed with caution and not simply pay whatever bill UC presents, given that UC (rather than the state) controls its pension costs and sets benefits levels for its employees; i.e., the state may choose to re-start state contributions to UC under the right conditions.

As discussed in greater detail in the higher education section of this report, the budget includes a $90 million base budget augmentation which the Administration indicates "can be used to address costs related to retirement program contributions." That these funds are not directly tied to retirement program contributions is indicative of issues identified above by the LAO. In considering the Administration's approach, the Legislature may want to clarify how any such augmentation could be construed. For example, under one view, the $90 million is a budget backfill for internal shifts and/or reductions that have already been implemented in light of the fact that UC restarted employer contributions to UCRP several years ago. In the alternative, the $90 million could also be viewed as representing new state costs (in 2012-13).

CSU Retirement Costs. As discussed in greater detail in the higher education section of this report, the budget proposes to adjust CSU's budget one last time for retirement costs, including its required employer contribution to CalPERS and for retired annuitant health benefits. These costs, and any future adjustments, would then be covered from within CSU's base budget; i.e., the state General Fund would no longer account for the annual adjustment, be it a cost increase or a cost decrease. Per the "funding agreement" and contingent on CSU's performance on specific metrics, CSU's base budget could grow but these retirement costs would be covered from within the base budget.

By bringing these costs onto CSU's base budget, the Administration intends for CSU to consider them in its budget and fiscal outlook; in essence, the Administration is trying to incent CSU to operate efficiently and effectively and balance all of its needs within its budget. From CSU's perspective, this approach adds costs that have been historically covered by the state budget and, further, is not completely within the employer's control. For instance, the CalPERS Board sets the employer contribution rate. But this is not unique to CSU as an employer; this also applies to the state as well as every other public employer who contracts with CalPERS. Employee pension contributions are negotiable; however, as the LAO has reported, there are strict legal protections that limit government's flexibility to impose increased employee contributions. Rather, for many current employees such contribution increases would be implemented only through negotiations, and in any event, would result in many employers providing comparable offsetting advantages, such as increasing pay or other compensation, to offset the financial effect of the higher pension contributions. This would tend to erode any savings from increased employee pension contributions.

Given that the state does not collectively bargain with CSU employees (note, the 2010 reforms described above pertaining to reduced pension benefits for new hires effective January 15, 2011, includes new CSU hires as of that date), the Administration has identified a valid issue with CSU and its management of its retirement costs – whether the state General Fund should continue to cover changes in CSU's retirement-related costs beyond the amount provided in the base budget. However, if the budget proposal is not the "right" approach, the Legislature may wish to consider other possible approaches and what changes might be needed to implement those other approaches.

Unemployment Insurance

BACKGROUND:

The Unemployment Insurance (UI) program is a federal-state program, authorized in federal law but with broad discretion for states to set benefit and employer contribution levels. The UI program provides weekly payments to eligible workers who lose their jobs through no fault of their own. Benefits range from $40 to $450 per week, depending on earnings in a 12-month base period. The program is financed by unemployment tax contributions paid by employers, based on the number of employees, on the first $7,000 of taxable wages paid to each employee. The contribution schedule is comprised of seven schedules, ranging from AA to F, with a range of 0.1 percent (the lowest rate on Schedule AA) to 6.2 percent (the maximum rate on Schedule F). Current law also includes a provision to add a 15 percent emergency solvency surcharge when the UI fund reserve is low (Schedule F+). California employers have been on this emergency F+ schedule since calendar year 2004.

The UI Trust Fund (UI fund) became insolvent in January 2009 and ended that year with a shortfall of $6.2 billion. The contributing factors to the insolvency of the UI fund are: (1) significant statutory increases to the UI benefit level that began in 2002 – these legislative changes increased the maximum weekly benefit amount from $230 per week to $450 per week; (2) no change in the UI financing structure despite significant increases to UI benefits – for example, the taxable wage ceiling has remained at the federal minimum level of $7,000 since 1983; (3) the inability of the fund to build a healthy reserve in the last decade – the Employment Development Department indicates that the existing UI financing system can be sustained in the long run only if the state unemployment rate averaged around four percent over time; and (4) the current economy which resulted in increased UI benefit payments and decreased revenues.

With the UI fund insolvent, the state began borrowing funds from the Federal Unemployment Account in order to continue paying UI benefits to qualifying claimants without interruption. The UI fund deficit was $9.8 billion at the end of 2011 and is expected to increase to $11.7 billion at the end of 2012. Generally, loans lasting more than one year require interest payments; the federal American Recovery and Reinvestment Act (ARRA) of 2009 provided temporary relief to states from making interest payments on UI loans through December 31, 2010. With the expiration of the ARRA provisions, interest of $303.5 million was paid in September 2011 and the budget includes an interest payment due in September 2012 totaling $417 million (estimated). Interest will continue to accrue and be payable annually until the principal on the federal UI loan is repaid. Federal law requires that the interest payment come from state funds.

The September 2011 interest payment of $303.5 million was made by borrowing funds from the Unemployment Compensation Disability Fund (DI Fund). Under current law, those funds are to be repaid from the General Fund to the DI Fund by 2016.

Federal law also includes provisions to ensure that a state does not continue to incur loans over an extended period. Specifically, if a state has an outstanding loan balance on January 1 for two

consecutive years, the full amount of the loan must be repaid before November of the second year or employers face higher federal UI taxes. Due to California carrying an outstanding loan balance for two consecutive years, the Federal Unemployment Tax (FUTA) credit will decrease from 5.4 percent to 5.1 percent on January 1, 2012. This will result in employers paying an additional $21 per employee per year; the aggregate increase in employer costs in 2012 is $300 million (estimated). These additional federal taxes pay down the principal on the federal loan. The FUTA credits will continue to decrease by 0.3 percent each year until the federal loans are paid in full (and the UI fund is solvent). In 2013, the increased cost is $50 per employee (estimated); the aggregate increase in employer costs in 2013 is $606 million (estimated).

GOVERNOR'S PROPOSAL:

Similar to the approach taken in 2011-12, the budget loans $417 million from the DI Fund to the General Fund to pay the September 2012 interest payment due to the federal government. The budget does not include a payment from the General Fund to the DI Fund to begin repayment of the 2011 loan from the DI Fund. Rather, the budget proposes to repay the $303.5 million due to the DI Fund by increasing the amount of the employer surcharge discussed below.

To fund future interest payments for funds borrowed from the federal government to pay UI benefits, and to repay the funds borrowed from the DI Fund in both 2011 and 2012, the budget increases, through trailer bill language that requires a 2/3rds vote (effective January 1, 2013), the employer surcharge payable to the Employment Training Fund by a total of $472.6 million ($39 per employee). The surcharge would be eliminated once the UI debt to the federal government is fully paid back and there is no longer a need to pay interest payments. Until that point is reached, the Administration indicates that this proposal would increase taxes on nearly every California employer by between $40 and $61 per employee per year, fluctuating each year to fully fund the interest costs due to the federal government.

In conjunction with the employer surcharge, the budget increases the minimum monetary eligibility to qualify for UI benefits to account for increases in employee wages that have occurred since the requirements were last adjusted in 1992. Under current law, to meet monetary eligibility requirements, a claimant must have earned: (1) at least $900 in a single quarter and total base period earnings of $1,125 or (2) at least $1,300 in any one quarter in the base period. The budget increases the minimum eligibility to: (1) $1,920 in the highest quarter and total base period earnings of $2,400 or (2) at least $3,200 in any one quarter in the base period. With these changes, approximately 40,000 individuals would no longer be eligible for UI benefits, saving $30 million per year.

ISSUES TO CONSIDER:

The Current State of the Economy. In developing its proposal, the Administration indicates that it took into consideration the current state of the economy and its recovery, and the potential cost impacts that an overall UI solvency proposal would present to employers (and the economy). By acting now to comprehensively address UI fund insolvency, the Legislature could stop the growth of the UI fund deficit and reduce associated state interest costs. On the other hand, such actions have the disadvantage of increasing employer costs and/or decreasing aid to unemployed workers during a difficult economic time for the state. However, continuing with a large outstanding federal loan will also increase costs to employers through reduced federal tax credits.

The Budget Does Not Contain a Comprehensive Solution to the Issue of UI Trust Fund Insolvency. Funds raised by the Governor's proposed employer surcharge would be limited to repayment of interest on the federal loans to keep the UI fund solvent. While this approach protects the General Fund from bearing these costs and prevents the state from accruing additional internal debt to make the federal interest payments, the proposal does little to address either the insolvency of the UI fund or the long-term structural imbalance between UI fund revenues and expenditures. Continuing to carry a balance on the loan to the UI fund will result in automatic and gradually increasing federal employer UI-related tax increases which pay down the principal on the federal loan to the state's UI fund. The potential drawbacks of the budget proposal include that it: (1) takes longer to repay the federal loan (resulting in higher interest costs) than otherwise would be the case; (2) concentrates the impact of repaying the federal loan almost entirely on employers; and (3) does not comprehensively address the structural imbalance in the UI fund. In its initial review of the Governor's budget, the LAO recommended that the Legislature consider a more comprehensive plan, one that makes more significant increases to employer taxes and/or decreases to benefit payments, to address the structural imbalance in the UI program and allow for more timely repayment of the federal loan.

The Underlying Financial Structure of the UI Trust Fund is Key. One of the contributing factors to the current UI fund insolvency is the inability of the fund to build a healthy reserve in the last decade. In prior decades, the fund balance built sufficient reserves during times of economic expansion so that the lowest tax rate schedule could be used before entering a period of economic contraction. This pattern ended in the 1990s. In the years leading up to the recession of the early 2000s, the UI fund was unable to build a high enough reserve to safely cover the next recession. Employers were still on schedule C in the late 1990s and in the early 2000s, as the state entered into a brief recession. Soon after, benefits levels were increased with no changes to the revenue structure. As the state entered this most recent recession in 2008, in which the unemployment rate hit record highs, the fund had an insufficient reserve, even though employers had been on the highest state tax rate schedule F+ since 2004. The EDD estimates that even as more firms pay higher rates under the F+ schedule, the current system can only generate about $6 billion in annual revenues. The situation in the late 1990s and early 2000s suggests that the UI financing system was not robust enough to build sufficient reserves. According to EDD estimates, the existing UI financing system can be sustained in the long run only if the state unemployment rate averaged around 4 percent over time. Such low rates of unemployment have been historically rare in California.

Potential Solutions to UI Trust Fund Insolvency. As the LAO noted in its October 2010 report entitled, *California's Other Budget Deficit: The Unemployment Insurance Fund Insolvency*, the Legislature essentially has three main choices for returning the UI fund to solvency – reducing benefit payments, increasing employer tax contributions, or adopting some combination of the two. To assist the Legislature, the LAO examined multiple scenarios for achieving solvency and found that: (1) decreasing UI benefits alone cannot address the fund insolvency in the near future; (2) options involving UI tax increases could quickly improve the fund condition; (3) employer tax increases could hurt California's competitiveness; and (4) the UI financing structure is not sufficiently robust.

Further complicating consideration of these issues, the Administration points to the fact that there are 28 other states that face a similar situation with their UI Fund, indicative that this is a national issue which may be addressed on the federal level. In its July 2011 report entitled, *Managing California's Insolvency: The Impact of Federal Proposals on Unemployment Insurance*, the LAO noted that three federal proposals had been introduced to address the insolvency issue and determined that all three would improve the solvency of California's UI fund. However, it remains unclear whether any federal reforms will be enacted. This uncertainty complicates the Legislature's decision as to how it should address the insolvency of its UI fund. The LAO recommended that regardless of whether Congress acts to address the UI insolvency problems faced by California and other states, the Legislature should ensure implementation of a long-term solvency plan by 2014. If federal reforms are enacted, it is likely that no additional action by the Legislature will be necessary to ensure long-term solvency. However, if no federal reforms are enacted, it will be critically important for the Legislature to adopt its own long-term solvency plan.