V. THE CALIFORNIA FRAMEWORK

A. THE STATE FUND AND THE CALIFORNIA CONSTITUTION

This is the first of four issues which are considered critical to the privatization decision. The California Constitution contains several references to the State Fund, thus a threshold question is whether privatization will require a Constitutional amendment.

Article XIV, Section 4 of the California Constitution vests the Legislature with plenary power to "create and enforce a complete system of workers' compensation." According to this section of the Constitution, a "complete system of workers' compensation includes ... full provision for regulating such insurance coverage in all its aspects, including the establishment and management of a State compensation insurance fund." In the last paragraph of this passage, the creation and existence of the State Fund is "ratified and confirmed." The plain meaning of this passage is that the Legislature is authorized, not mandated, to create a "complete" workers' compensation system. The question presented by the Governor's proposal is whether the Legislature, once it has invoked its constitutional grant of power under Article 14, Section 4, retains discretion to modify the components of a "complete system" nearly a century later.

One interpretation would require the Legislature to include *all* of the elements listed in the constitutional passage, including the "establishment and management of a State compensation insurance fund," in any "complete" system of workers compensation it creates. Under this interpretation, State Fund (as an entity) is constitutionally protected and cannot be abolished without amending the Constitution. Another interpretation would allow the Legislature to choose selectively amongst the list of elements of a workers compensation system contained in Section 4. Under this interpretation, a state fund is not essential, and State Fund (as an entity) could therefore be abolished without violating the Constitution. The attorneys contributing to this study feel that both interpretations are legally viable, that there would be significant potential for litigation in the event of privatization of State Fund, and that the outcome of such litigation cannot be predicted at this time.

B. CONTRACTING OUT

One argument has arisen that, even if the section of the California constitution concerning workers compensation permits the privatization of State Fund, another section, that setting up the civil service system, prevents the privatization of any function which has, and still can be, done by civil servants. This has not been a problem dealt with by other states and, indeed, the California Constitution, in terms, says nothing about contacting out government functions to the private sector. The history which has led to this possible legal problem, and its likely resolution outside of this study, merit a brief description.

In 1934, responding to ballot arguments to avoid "appointment of inefficient employees for political reasons" and to promote economy, the voters made part of the Constitution what is now Article VII. That provides that the civil service includes every officer and employee of the state, and that permanent appointments shall be made based on a general system of merit ascertained by competitive examination.

This was followed by a judicial construction which implied a ban on contracting out. Two Supreme Court cases from that era implied a "true test" that contracting out is impermissible where the tasks "could be performed by one selected under the provisions of the civil service." When this proved unworkable for modern times--for under this test, a state employee could not have a flat tire fixed by the automobile association, so long as civil service had a category of state garage mechanic--the courts of appeal devised exceptions. One devised a "new state function" test[1] which was followed by a "cost savings test"[2] (possibly conditioned on no displacement of existing state employees). Most recently, legislative privatization of the traditional state function of designing and constructing roads, by making them tollways, was upheld in an apparent extension of the idea that this made the function "new."[3]

The validity of the Supreme Court's inference, over half a century ago, that the protection of civil service is incompatible with privatization--which has been made in no other state with a similar civil service provision--is about to be reviewed by the California Supreme Court. In June 1996, the Supreme Court granted the first petition in decades--to review a court decision approving the California Department of Transportation's (Caltrans) having contracted out road engineering, despite the fact that state engineers had done the work for years. The Caltrans petition specifically raised the issue whether the original inference that the Civil Service requirement to select "based on a general system of merit" constrains privatization. The petition was granted without limitation as to the issue to be reviewed.[4]

Prediction of what the Supreme Court will rule is unlikely to be fruitful, beyond observing that some fundamental shift is likely, because the judicially created exceptions are not truly compatible with the original ban, nor with each other. Given the likelihood of a sweeping Constitutional ruling on privatization, the difficult task of applying the varying models of State Fund privatization to the conflicting lower court holdings--"toll road privatization," "cost savings," or "new

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[1] California State Eees Assn. v. Williams (1970) 7 Cal.App.3d 390, 396
[2] Calif. State Eees Assn. v. Calif. (1988) 199 Cal.App.3d 840, 851
[3] Professional Eng'rs in Cal. Gov. v. Dept. of Transportation (1993) 13 Cal.App.4th 585, 593
[4] Professional Eng'rs in Cal. Gov. v. Dept. of Transportation (1996)___ Cal.App. 4th____, 54 Cal.Rptr.2d 42.

function"--seems more academic than useful. By the time any legislative action is called for, the Supreme Court should have issued a decision in the Caltrans case.

C. FEDERAL TAXATION

State exclusive and competitive workers compensation insurance funds, as well as some state-mandated mutual workers compensation insurance funds and mutual workers compensation insurance authorities, pay no federal income taxes. Among the varieties of other states' privatized workers compensation insurance arrangements, which mix public and private status, some claim federal tax exemption, based on legal status or the public nature of the insurance function performed, while others do not. Tax counsels' arguments for federal income tax exemption for state workers compensation insurance providers generally focus on the provider's organizational nexus to the state, and the degree to which their insuring functions are peculiar to government, in contrast to the insuring functions of private insurers. No assessment has been made in this study regarding whether exemption from federal income taxes conveys a competitive advantage to state workers compensation providers. The cost advantage of federal income tax exemption, if any, however, is probably no more than 1% to 2% of premium. In situations in which workers compensation insurance generates insurance losses, of course, there is no competitive advantage to exemption from federal income taxes.

D. THE CONTEXT FOR PRIVATIZATION

The Competitive Government Initiative, with its premise of rightsizing and reinventing government, has found a great deal of support from both the business community and the public in general. Indeed, employers and insurers specifically have often voiced their support for reducing the regulatory burden of government.

While these propositions are generally accurate, it is also true that across the country it has been difficult to privatize a state fund or alter a residual market mechanism when the system is deemed to be functioning adequately or reasonably well. As the chart "Summary of State Fund Structure Changes" at page 20 makes clear, in those states where changes have been made to state funds or where mutual insurers or authorities have been created to replace an assigned risk pool, a "system in crisis" provoked the change. These types of conditions do not exist in California, and it is difficult to argue convincingly that the system is in crisis.

Major participants, trade associations and individual California employers representing large and small industries have not endorsed privatization, while some associations have expressed opposition. Other insurers have been cautious about expressing their support or opposition to privatization but raise the issue about residual markets and the

need to create a workable assigned risk plan for which they would be liable. No unqualified support among the involved parties has emerged since announcement of the Competitive Government Initiative last April.

Any proposal to privatize the State Fund will need to address these concerns.