# Furloughs

# (LEOFF 2 Proposal)

## Issue

The Law Enforcement Officers' and Fire Fighters' Plan 2 (LEOFF 2) Board has requested coordination in addressing the effects of budget-related salary reductions on pension benefits. Specifically, the Board wishes to address the effects on pension benefits for members of LEOFF resulting from general salary reductions, and any reduction or elimination of a previously negotiated salary increase. At issue for the SCPP is the decision whether or not to study expanding these effects in other retirement systems.

## Procedural Standing

At their December 15 meeting, the Board will review a LEOFF 2 staff bill draft for possible recommendation to the Legislature. LEOFF 2 staff has provided a preliminary bill draft to the SCPP for review. This staff bill draft has not been reviewed or approved by the Board, and prior LEOFF 2 staff analysis has not addressed the bill draft directly.

An actuarial fiscal note is not available for the staff bill draft, but OSA will provide preliminary sensitivity analysis at the SCPP's December 14 meeting. Full fiscal analysis is contingent on obtaining data. OSA staff requested data from LEOFF 2, and received some preliminary data from the Washington State Association of Counties and the Association of Washington Cities.

## Issue Development

In June 2010, the Board wrote to the SCPP requesting coordination between the two entities in preparing possible legislation for the 2011 Session. The Board advocated expanding pension protections enacted for PERS members in 2009 to members of other systems, including LEOFF Plan 2.

In September 2010, the SCPP held a work session to discuss the LEOFF 2 Board's request. After the meeting, no further action was taken.

In November 2010, the Board wrote to the SCPP to note that few LEOFF 2 members were subject to furloughs, but that salary reductions and foregone wage increases

were common and had the same overall effect on the members as furloughs. As such, the Board advocated a modified proposal. The modified proposal would expand the definition of "furloughs" enacted in prior legislation to include salary reductions or foregone wage increases due to budget reductions.

At the November SCPP meeting, Board staff stated that draft language had been submitted to OSA staff in preparation for the Board's review and possible approval at its December meeting. The Executive Committee of the SCPP requested a work session on that draft.

# Defining Furloughs

In the context of public employment, "furloughs" typically refers to unpaid leaves of absence or temporary layoffs. They can be voluntary or mandatory. In response to budgetary constraints, furloughs have been used by many public agencies to temporarily reduce staffing costs without laying off staff. Furlough plans commonly involve either shutting down the office for one or more days, or allowing individual employees to take unpaid leave.

While they may not be exempt from budget cuts, public safety personnel, including police, fire, and other emergency services, are typically exempt from furlough plans. There is no state wide furlough policy or exhaustive list of furlough plans, but staff has only confirmed one entity that has enacted mandatory furloughs on police or fire.[1]

[1] *City of Bremerton.*

## *Furloughs Can Impact Pension Benefits*

Furloughs reduce the amount of salary that is earned by employees. This, in turn, can impact a member's pension benefits by affecting salary average or service credit. Members may be able to minimize or avoid these impacts by working longer before retirement, or purchasing additional service credit at retirement.1

Please see the September issue paper for more information on pension calculation and service credit rules: http://www.leg.wa.gov/SCPP/Meetings/Pages/Sep10.aspx.

### Salary Average

Salary average varies by plan, but is generally based on the member's highest consecutive two or five years of employment. If an employee is furloughed during the two- or five-year span used to calculate salary average, that employee's pension benefits may be reduced.

For most employees, salary is highest near retirement. Employees who are furloughed five or more years before retirement are less likely to have their pension calculations affected by salary reductions.

**Service Credit**

Members are not likely to lose service credit due to furloughs. For example, a full-time employee subject to the ten shutdown days included in ESSB 6503 would not lose service credit. Partial service credit is also available and varies by plan.

# Current Law

Two bills were passed in the last two years; one in each of the prior legislative sessions. The following is a brief description of the framework created by these bills. Please see the September issue paper for more details.

http://www.leg.wa.gov/SCPP/Meetings/Pages/Sep10.aspx

Under each of the prior bills, the plan administrator works with retirees and employers to determine whether furloughs will affect a retiree's salary average. Upon retirement, the Department of Retirement Systems (DRS) asks the retiree if he or she was affected by furloughs during the 2009-11 Biennium. If so, DRS will ask the employer to certify what the retiree would have earned had it not been for the reduction and that the reduction was an integral part of that employer's expenditure reduction efforts.

Based on that certification, DRS will adjust the retiree's salary average so that the member's pension benefits are calculated as though the member had not been furloughed. This is an after-the-fact adjustment based on what the employee would have earned, and the retiree does not directly receive compensation for time not worked.

Current law only includes salary reductions due to:

- Reduced work hours.
- Mandatory or voluntary leave without pay.
- Temporary layoffs.

Current law applies the salary average protection provision to the following retirement system members.

| Salary Average Protection Provisions Created by SB 6157 (2009) and ESSB 6503 (2010) | | |
|---|---|---|
| | Local | State |
| PERS | X | X |
| TRS | | X |
| SERS | | |
| PSERS | | X |
| LEOFF | | X |
| WSPRS | | X |

The salary average adjustment in current law creates an indeterminate cost to the system because no contributions are collected for the time the employee does not work. This cost must be absorbed by the affected retiree's retirement plan (i.e. passed to active members and employers).

For more information, please see the actuarial fiscal notes for the prior legislation.

SB 6157 (2009):
https://fortress.wa.gov/ofm/fnspublic/legsearch.asp?BillNumber=6157&SessionNumber=61

ESSB 6503 (2010):
https://fortress.wa.gov/ofm/fnspublic/legsearch.asp?BillNumber=6503&SessionNumber=61

# LEOFF Proposal

Draft language provided by LEOFF 2 staff (attached) makes three changes to existing law for LEOFF members:

- Expanded coverage.
  - Current law applies the salary average adjustment to compensation foregone due to reduced work hours, mandatory or voluntary leave without pay and temporary layoffs. The staff bill draft would also apply the adjustment to all other salary reductions (such as percentage reductions across-the-board ), and reductions or eliminations of previously contracted salary increases (such as salary freezes or foregone step increases). To be considered for the adjustment, a reduction must be certified by the employer as an integral part of the employer's expenditure reduction efforts.
- Application to local government employees.
  - Current law applies to state LEOFF employees and does not cover local government LEOFF employees. The staff bill draft would apply both the current provisions and new provisions to all

members of LEOFF, including both state and local. As of the June 30, 2009, Actuarial Valuation, only 114 of the 16,951 active members are state employees.

- Modified timeframe.
  - Current law applies to reductions experienced during the 2009-11 Biennium. The staff bill draft would alter this in three ways:
    - ☐ Current provisions for state LEOFF employees would be extended to the 2011-13 Biennium.
    - ☐ Current provisions would apply retroactively for local government LEOFF employees and would apply for both the 2009-11 and 2011-13 Biennia.
    - ☐ New provisions would apply retroactively and would apply for both the 2009-11 and 2011-13 Biennia.

The full text of the draft provided by LEOFF 2 staff is attached. However, the crux of the proposal is contained in the following changes to RCW 41.26.030(15)(c):

- In calculating final average salary under (a) or (b) of this subsection, the department of retirement systems shall include any compensation forgone by a member ~~((employed by a state agency or institution))~~ during the 2009-2011 fiscal biennium <u>or the 2011-2013 Fiscal Biennium</u> as a result of <u>salary reductions, reduction or elimination of previously contracted salary increases,</u> reduced work hours, mandatory or voluntary leave without pay, or temporary layoffs if the reduced compensation is an integral part of the employer's expenditure reduction efforts, as certified by the employer.

## *Administration*

Based on the bill draft provided by LEOFF 2 staff, DRS would administer the proposal in the same way as the prior furlough bills: In addition to asking a retiree if he or she was affected by furloughs, DRS will inquire whether the retiree was affected by other salary reductions (e.g. across-the-board salary reductions) or a reduction or elimination of a previously contracted salary increase (e.g. salary freeze or foregone step increase).

If the retiree answers in the affirmative, DRS will ask the employer to certify what the retiree would have earned had it not been for the reduction, and adjust the retiree's salary average accordingly.

As currently drafted, the LEOFF 2 staff bill draft would apply prospectively only. The retroactive provisions (see above) would apply only to those who have not yet retired. In other words, DRS will not adjust benefits for retirees who have retired prior to the effective date of the proposal. To illustrate, here is one possible scenario:

A LEOFF member who worked for a local government was furloughed during the 2009-11 Biennium. That member retired, and did not receive a salary average adjustment since LEOFF local government employees are not covered under current law. Sometime after the member has retired, the LEOFF 2 bill passes (as currently drafted), and LEOFF local government members are now covered back to the beginning of the 2009-11 Biennium. DRS would not adjust that retiree's benefits to account for the furloughs.

## *Cost*

The cost of the Board staff draft is indeterminate at this time. Preliminary sensitivity analysis will be presented at the December SCPP meeting, but a complete analysis will be contingent on obtaining additional information regarding the extent of salary reductions for each of the affected members and how the language of the staff bill draft is interpreted.

In general, the extent of salary reductions is not yet known because employers report what an employee earned, and not what the employee might have earned. Employers do not report furloughs to DRS, and data is obtained only after the retiree requests an adjustment. Similarly, employers do not report reductions in salary or foregone increases. As noted above, staff is working to obtain data on budget cuts and salary reductions.

We also do not yet know how the LEOFF 2 staff bill draft will be interpreted. This issue is discussed in greater detail below.

Any cost for salary average adjustments for retirees affected by salary reductions in the staff bill draft would be absorbed by the retirement system (i.e. passed to all members and employers). This is because no contributions are made by either the employer or employee for time the employee does not work or salary that is foregone. This structure is consistent with current law for salary average adjustments for retirees impacted by furloughs.

If the proposal is limited to LEOFF 2 members only, then any of the 16,951 active members (as of the 2009 actuarial valuation) could be affected, and the plan would absorb the cost. If expanded to other systems, then potentially any of the 301,838 active members could be affected, though the most likely to be affected are those who are currently eligible for retirement, or are within seven years of retirement. For those who are affected, the cost would be absorbed by the appropriate plans. Contribution rates will likely increase to cover the increased cost.

# Should The Proposal Be Applied To Other Systems?

The LEOFF 2 staff bill draft applies only to members of LEOFF, and may not be directly portable to other systems. However, the SCPP may wish to study whether the approach should be applied to other systems. In other words, should employees in other state retirement systems receive a salary average adjustment in response to expenditure reduction efforts other than furloughs?

Furlough plans are typically just one part of a broader expenditure reduction plan, and many public entities are experiencing compensation reductions that may not fit the current furloughs provisions. If the SCPP chooses to study broader application of the proposal, there are several subsidiary issues the committee may wish to address.

## *Who Should It Apply To?*

Policy makers may wish to decide whether to study the application of this proposal to all other public employees, or to those whose duties or job classifications make them similarly situated to members of LEOFF. Many public entities in various job classes and retirement systems have experienced budget reductions to some extent, and many of these reductions have taken the form of salary reductions or foregone increases.

Previous legislation addressed the pension impact of reduced work hours and temporary layoffs. The Board has stated that public safety and emergency personnel, due to the nature of their duties, are not able to use reduced work hours or temporary layoffs as a means of reducing expenditures. However, those entities may still be experiencing other forms of salary reduction, resulting in a lower salary average when calculating pension benefits.

Public safety and emergency personnel serve in other systems in addition to LEOFF, and these employees may be having a similar experience to the members in LEOFF. This may include, for example, state troopers in WSPRS, prison guards in PSERS, or state hospital employees in PERS.

## *How Long Should Salary Average Adjustment Provisions Be In Effect?*

The salary average adjustment provisions enacted in the last two sessions were temporary measures covering reductions in the 2009-11 Biennium. The current staff bill draft expands this for another biennium.

The SCPP may wish to ask if the proposal will be a one-time extension, or if it will be necessary to continue extending the provision for additional biennia. The SCPP may

also wish to study whether a temporary measure, if consistently extended, could acquire permanent status. For example, the SCPP may wish to study whether applying the salary average adjustment in current law over multiple biennia could permanently redefine the calculation of salary average.

### *Are There Plan Qualification Issues?*

If a retirement plan does not adhere to certain criteria, it may lose preferential tax status. The SCPP may wish to study any potential tax implications from this proposal, or solicit advice from tax counsel.

Some initial questions for consideration may include whether there are limits to the amount of benefits that can be provided for compensation that has not been earned, and whether benefits are definitely determinable if they involve speculation about what an employee might have earned.

## Uncertainty Over Interpretation of Bill Language

There are many ways to interpret the language of the attached LEOFF 2 staff bill draft, and those interpretations may have unintended consequences. This uncertainty is reflected in the preliminary fiscal analysis above. If the Board approves the staff bill draft, or a similar draft at the Board's December meeting, the SCPP may wish to study its implications for the retirement systems.

This uncertainty in interpretation could also lead to perceived abuse.

### *How Will The Bill Language Be Interpreted?*

The bill draft provided by LEOFF 2 staff applies the salary average adjustment to "salary reductions, [and] reduction or elimination of a previously contracted salary increase" that are certified by the employer as integral to the employer's expenditure reduction efforts.

Determining which reductions fit under the LEOFF 2 staff bill language will depend on:

- How much foregone salary can be included?
- What are "salary reductions"?
- What is "integral"?
- What does "previously contracted" mean?
- What are the contract terms?

- Will there be an incentive to shift economic impact from employees to the pension system?

*How Much Foregone Salary Can Be Included?*

There are no limits under either current law or the LEOFF 2 staff bill draft. Under current law there is no limit to the amount of furlough days that can be included for the adjustment. Under the staff bill draft, there is also no percentage or dollar value limit on the amount of foregone salary that can be included.

*What Are "Salary Reductions"?*

The term "salary reductions" as applied to LEOFF members likely means reductions in "basic salary" which is a defined term in the LEOFF statutes. This term is defined differently for Plan 1 and Plan 2.[2] For example, if "salary reductions" means "basic salary", LEOFF Plan 2 members will receive pension credit for foregone overtime, while Plan 1 members would not.

The term "salary reductions" could also refer to any mechanism that directly reduces actual salary, as opposed to other types of compensation, such as subsidized health benefits or vehicle allowances. However, since the term is not defined it could be subject to different interpretations, and some employers may interpret this as including those other types of compensation.

Lacking a concrete definition, this may result in little or no uniformity between public entities, or even between employees within a single department. In other words, two retirees who experience identical salary reductions could receive different salary average adjustments depending on how the employer characterizes the reductions and interprets the provision.

*[2] See RCW 41.26.030(4).*

*What Is "Integral"?*

Theoretically, any action which reduces expenditures could be considered integral to the employer's expenditure reduction efforts. What constitutes an "integral" reduction may be both a matter of opinion, and an ethical decision for the employer.

One example may be an employer and employee creating a special deal for an individual employee, such as a phased retirement. In other words, an employee may voluntarily reduce his or her hours, perhaps down to working only half time. If certified as integral by the employer, that employee's pension benefits would be calculated as though he or she worked full time.

*What Does "Previously Contracted" Mean?*

It is not clear whether the term "previously contracted" would be interpreted as meaning previous to the passage of a bill, or previous to the reduction in salary. If it were interpreted as meaning previous to the passage of a bill, then this provision is likely limited to the terms of employment contracts currently in existence.

However, if it were to be interpreted as previous to the reduction in salary, it could affect future contracting. For example, employers and employees could agree to insert language into future contracts stating the employees would have received much higher salaries if not for the current budget. This could also be done in exchange for retaining other compensation, as noted below.

*What Are The Contract Terms?*

Not all employees are under the same employment contract, and not all employees have a written contract. For employees represented by collective bargaining, there is likely a single document, or set of documents containing all the terms for that bargaining unit. Many public employees are represented by collective bargaining, including most LEOFF employees, and the contract terms will vary with every contract. If the current staff bill draft were to be applied to employees who are not represented by collective bargaining, it may be necessary to determine what constitutes the terms of the employment contract for those employees.

*Will There Be An Incentive To Shift Economic Impact From Employer Budgets To The Pension System?*

Employers and employees may have an incentive to find ways to shift costs to the pension system. To illustrate, if an employer is planning to cut back on other types of compensation, the parties may trade that other compensation for an equivalent cut in direct salary, since the foregone salary will still be counted at retirement. This may be most desirable for employees near retirement, who may be better able to handle reduced pay for a short time in exchange for a larger pension.

## *Will The Certification Requirement Prevent Perceived Abuse?*

As a general rule, uncertainties in interpreting, quantifying, and verifying can each increase the potential for inconsistent application. Inconsistent application can result from reasonable, but differing interpretations, or from genuine abuse.

Abuse may include activity that is not actually illegal, but is designed to maximize the employees' benefit at the expense of the system, as these actions may run counter to the intent of the underlying proposal. However, there are no rules or guidelines in

current law or in the LEOFF 2 staff bill draft to determine what constitutes abuse, and no penalties for violation.

A provision of current law (retained in the staff bill draft) was intended to prevent abuse. Under current law, the retiree will not receive the salary average adjustment unless the employer certifies the furlough was an integral part of the employer's compensation reduction efforts. DRS will rely on this certification to administer the provisions of this bill draft as well.

The certification provision is still relatively new, and it is not yet known whether or not it will be effective in deterring abuse. The effectiveness of the certification provision could affect both current law and the approach used in the staff bill draft.

The certification provision could also raise other plan administration questions. For example, what level of review or audit is expected or required of the plan administrator?

## Conclusion

The bill draft provided by LEOFF 2 staff expands the provisions of the prior furloughs legislation to additional types of compensation reductions, and applies those provisions to additional employees. Further, LEOFF 2 staff bill draft extends both new and old provisions for an additional biennium.

Expanding the salary average adjustments as described in the proposal may increase costs to LEOFF because no contributions are collected for compensation the employee did not receive.

Policy makers may wish to study whether this, or a similar proposal should be applied to all public employees, or public safety and emergency employees in other systems. The SCPP may also wish to study any aspects of any bill draft approved by the Board.

## Special Session

During the second special session, the Legislature passed HB 3225. As of this writing, it has not been signed into law. OSA is currently studying the potential pension impacts of HB 3225, and those impacts are not yet known.

The bill affects the salary average adjustment provisions by inserting the following (or substantially similar) language into statutes for PERS, TRS, LEOFF, PSERS, and WSPRS:

> *In calculating earnable compensation under (a) or (b) of this subsection, the department of retirement systems shall include any compensation forgone by a member employed by a state agency or institution during the 2009-2011 fiscal*

*biennium as a result of reduced work hours, mandatory or voluntary leave without pay, temporary reduction in pay implemented prior to the effective date of this section, or temporary layoffs if the reduced compensation is an integral part of the employer's expenditure reduction efforts, as certified by the employer.*

# Next Steps

- Nothing more at this time. For example:
  - Not move on the issue generally.
  - Wait for the LEOFF 2 Board to recommend a bill draft.
- Request information from LEOFF 2 regarding some of the issues raised.
- Study applying the proposal to other retirement systems next interim.
  - All public employees.
  - Public safety and emergency personnel only.
  - Request input from tax counsel.
  - Request input from potential stakeholders.
- Study the potential pension impacts of the bill passed during special session (HB 3225).

# Materials

- Briefing Paper.
- Issue Paper (September 21, 2010).
- Stakeholder Correspondence from Kelly Fox, Chair, LEOFF 2 Board, received on the following dates:
  - June 17, 2010.
  - November 8, 2010.
- LEOFF 2 staff bill draft.

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