OVERSIGHT VRS Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY

The 1991 Early Retirement Incentive Program

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The program was developed in response to a projected State revenue shortfall. Analysis performed by the Department of Planning and Budget concluded that the program would create a net financial benefit for the State if the replacement of early retirees was kept to a minimum. The General Assembly authorized the program after the required budget savings for FY 1992 were increased. Judges and State Police were not eligible. Participation was optional for political subdivisions.

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A mandatory budget reduction target was created for each State agency. Agencies had to submit early retirement plans, containing estimates of the number of retirees and the need for replacements, to their Secretaries and to DPB. Based on their review of agency plans, DPB staff realized that the replacement rate for State early retirees would exceed 50 percent.

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The program enabled certain long-time employees to leave service under dignified circumstances, and allowed their employers to reduce their payrolls. However, it also produced a sudden, massive loss of leadership and expertise at the State level. The participation rates and position replacement rates for State early retirees exceeded the assumptions used by DPB in estimating the fiscal impact of the program. The program also created a large actuarial loss for VRS.

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Several key issues should be examined when evaluating a proposed early retirement program. These incude the tradeoff between short-term budget reductions and long-term pension liability; the program's relationship to overall budget reduction strategy; monitoring of position replacement; the rehiring of early retirees; and the proper recognition of all program costs.

Profile: 1991 Early Retirement Incentive Program

Eligibility:	VRS members, age 50 with 25 years service credit
Key Provisions:	Five years additional service credit, unreduced benefit, COLA in second year of retirement, $100 supplement until age 62
Early Retirement "Window" Period:	90 days beginning July 1, 1991
Number of Early Retirees:	3,535 (State); 2,607 (Political Subdivisions)
State Budget Savings (FY 1992):	$37.1 million
VRS Actuarial Loss:	$238.2 million (State employees); $119 million (Teachers)
Program Participating Rates of Eligible Employees:	67% (State); 72% (Teachers); 64% (Political Subdivisions)

The 1991 Early Retirement Incentive Program

INTRODUCTION

During the 1991 Session, the General Assembly enacted legislation establishing an early retirement incentive program for members of the Virginia Retirement System (VRS). This program, which was administered by VRS during 1991, provided eligible individuals with enhanced retirement benefits while also permitting an immediate reduction in personal services expenditures for the State. Approximately $37 million in budget reductions for FY 1992 was attributed to the early retirement program. A total of 3,535 State employees and 2,607 political subdivision and local school board employees retired early under the program.

In order to accurately evaluate the costs and benefits of an early retirement incentive program, a long-term view is preferable to a short-term view. Immediate reductions in personal services expenditures in the short term need to be balanced against increased pension benefit liability and expenditures over the long term. If a majority of the positions of early retirees are not subsequently refilled, and if replacement employees are hired at a lower salary than the early retirees, meaningful long-term cost reductions are possible. However, administrative and budgetary discipline is required in order to actually achieve such reductions.

One significant deficiency of the 1991 early retirement incentive program involved program monitoring and evaluation. Comprehensive, centralized data concerning the replacement of early retirees is incomplete and inadequate. A formal program evaluation and final written report, although originally planned by the Executive Branch, was not performed. Therefore, an exact count of early retiree replacements is not available. Calculation of an overall replacement rate might be possible by surveying each State agency, or by tracking the position classification number of each early retiree using data from VRS and the Department of Personnel and Training. However, research activities of that nature were beyond the staffing and time constraints of this study.

JLARC staff did review the early retiree replacement rates of six large State agencies which together comprised 53 percent of the State's early retirees. While replacement rates varied, five of the six agencies eventually refilled well over half of their early retiree positions. Overall, 66 percent of the early retirees in these six large agencies were eventually replaced.

In order to properly assess the likely advantages and disadvantages of a proposed early retirement incentive program, several issues should be addressed. These include a comparison of short-term budget reductions to long-term pension liability; how the early retirement program fits into an overall budget reduction strategy; whether and under what circumstances early retirees may be rehired by their employers; recognition of all administrative costs associated with program implementation; and monitoring and evaluation of program results. This report reviews the 1991 early retirement incentive program in terms of these key issues.

Study Mandate

At the July 1994 meeting of the JLARC Subcommittee on Virginia Retirement System Oversight, the subcommittee directed JLARC staff to conduct a review of the 1991 early retirement incentive program. According to the subcommitee, the review was to focus in particular on the extent to which the positions of early retirees at the State and political subdivision levels were subsequently refilled.

OVERSIGHT VRS Report

VRS Oversight Report **is published periodically by the Joint Legislative Audit and Review Commission (JLARC) in fulfillment of Section 30-78 *et seq.* of the *Code of Virginia.* This statute requires JLARC to provide the General Assembly with oversight capability concerning the Virginia Retirement System (VRS), and to regularly update the Legislature on oversight findings.**

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Study Approach

In order to properly address the study mandate, a dual approach was taken to this study. First, in order to develop a broad understanding of the objectives and results of the program, interviews and document reviews were conducted. Staff from the Department of Planning and Budget (DPB), the Virginia Retirement System (VRS) and the House Appropriations Committee (HAC) were interviewed. Documents provided by DPB, VRS and HAC were examined.

Second, in order to develop a more detailed understanding of how the program was implemented and what its effects were, six State agencies and ten local school boards which had large numbers of early retirees were selected for review. The following State agencies were examined: Department of Transportation (VDOT), Department of Mental Health, Mental Retardation, and Substance Abuse Services (DMHMRSAS), Department of Health (DOH), Department of Corrections (DOC), Department of Alcoholic Beverage Control (ABC), and Department of Motor Vehicles (DMV). The following local school systems were examined: Buchanan County, Chesapeake, Hampton, Lynchburg, Newport News, Portsmouth, Prince William County, Rockingham County, Tazewell County, and Washington County. Interviews and document reviews were conducted with appropriate staff from the selected State agencies and political subdivisions.

Report Organization

This report examines the design and implementation of the 1991 early retirement incentive program. The first section reviews the development of the program. The second section examines how the program was implemented. The third section assesses the experience of selected State agencies and political subdivisions with the administration of the program. The fourth and final section identifies issues that the General Assembly may wish to consider in the event of any proposal for a new early retirement incentive program.

EARLY RETIREMENT INCENTIVE PROGRAM DEVELOPMENT

The initial proposal for an early retirement incentive program was made by Governor Wilder's Administration. In order to provide support for its proposal, the administration calculated a cost savings estimate for the program based on assumed rates of employee participation and replacement. The General Assembly approved the program after significantly increasing the amount of budgetary savings that would be required from the program. The major plan provisions and underlying assumptions were not changed by the General Assembly. This section discusses the initial proposal for the program, and how that proposal developed into the actual program.

Administration Proposal in Response to Revenue Shortfall

The proposed early retirement program was part of an effort by Governor Wilder's Administration to address a projected revenue shortfall, and the resulting possibility of employee layoffs, that confronted the State in the summer of 1990. After Governor Wilder announced his desire to institute an early retirement program, an administration task force began work to develop a specific proposal. Representatives from the Department of Planning and Budget (DPB), Department of Personnel and Training (DPT), the Virginia Retirement System (VRS), the Secretary of Administration, and the Governor's Office served on the task force. Staff from the legislative money committees were also invited to participate.

Cost/Benefit Analysis. A major component of the task force's work was a cost/benefit analysis. This analysis, performed by DPB with the assistance of VRS, compared the present value savings from reduced personal services costs to the present value cost of increased retirement expenses. The cost/benefit analysis was based on 4,599 State employees who were determined, based on information available at that time, to be eligible for the proposed program. The analysis was also based on an estimated present value pension liability of $295.5 million. This analysis was performed assuming a number of different scenarios of overall replacement rates, and of varying salary differentials between retirees and replacement employees.

The analysis determined that the State would achieve a positive net savings at either a 50 or 66 percent replacement rate, with higher savings naturally occurring with 50 percent replacement. At a 75 percent replacement rate, the State would achieve real savings only if replacements were hired at salary steps one or three within the same pay grade as the retirees (Table 1).

In its technical summary of the early retirement proposal, DPB recognized the importance of minimizing the number of early retiree replacements.

> For the State to realize substantial savings, each person selecting early retirement should not be replaced. . . . if retiring employees are replaced, even at lower salary levels, savings to the State will not be sufficient to offset the added VRS costs of the program.

On a present value basis, DPB estimated that the State would achieve a net benefit of $104,000 per retiree assuming zero replacement, and a net loss of $35,000 per retiree assuming total replacement, if all replacements were hired at salary step five.

DPB also analyzed the costs and benefits of the proposal using a budget/cash flow approach. That analysis concluded that the program would require $13.5 million in additional annual employer contributions from FY93-FY96, while reducing annual payroll expenses by $60.5 million over the same period. Consequently, the analysis concluded that the State would achieve a net annual budget savings of $47 million from FY 1993-FY 1996.

Specific Elements of Proposal. Under the proposal to the General Assembly, all VRS members who were at least 50 years of age with 25 years of service credit on September 1, 1991 were eligible to retire early. Employees of political subdivisions who met the same age and service criteria were also eligible to retire early, provided that the governing body of the political subdivision elected to participate in the program. The proposal's specific incentives for early retirement included the following:

- cost-of-living-adjustment (COLA) beginning at retirement,
- supplemental benefit of $100 per month until age 62,
- five years of added service credit, and
- no actuarial reduction for early retirement.

Certain groups of public employees were not eligible to participate. These were: (1) members of the Judicial Retirement System and the State Police Officers Retirement System; (2) university faculty participating in the optional retirement plan; and (3) employees of the participating localities who are provided with special benefits for law enforcement officers and firefighters.

General Assembly Approval Premised on Increased Savings Target

The Governor's early retirement proposal to the General Assembly had three stated objectives: (1) to provide an alternative to employee layoffs; (2) to allow the State to realize a permanent reduction in employment levels; (3) to create permanent budget savings through reduced personal services costs. Given these objectives, VRS would in effect serve as a vehicle for implementing specific personnel and budgetary policies of the State.

The original legislative impact statement prepared by DPB estimated that the program would result in a $12.8 million net savings in salary and benefits in FY 1992. The fund split for the savings estimate was $4.7 million in general funds and $8.1 million in non-general funds. The program's cost savings estimate was based on two primary assumptions. First, 50 percent of eligible employees would retire early. Second, 50 percent of the positions vacated by early retires would be refilled by the employer.

The replacement and participation assumptions were developed by the Governor's task force. The participation assumption was based on the results of an employee survey. Originally, 30 percent participa-

Table 1: Results of Cost/Benefit Analysis for Early Retirement Incentive Proposal

Cost/Benefit	*Employee Replacement Salary Step*				
	Step 1	**Step 3**	**Step 5**	**Step 7**	**Step 9**
Present Value Pension Liability Per Retiree	$64,253	$64,253	$64,253	$64,253	$64,253
Net Savings Per Retiree with No Replacement	$103,688	$103,688	$103,688	$103,688	$103,688
Net Savings Per Retiree with 50 Percent Replacement	$39,829	$37,170	$34,388	$31,483	$28,442
Net Savings Per Retiree with 66 Percent Replacement	$18,543	$14,997	$11,289	$7,414	$3,360
Net Savings (Loss) Per Retiree with 75 Percent Replacement	$7,900	$3,911	$(261)	$(4,620)	$(9,181)
Net Loss Per Retiree with 100 Percent Replacement	$(24,029)	$(29,348)	$(34,911)	$(40,722)	$(46,804)

Source: Department of Planning and Budget.

tion was assumed. However, that assumption was increased to 50 percent based on updated survey data. The position replacement assumption was developed based on the judgment of the task force. Four additional assumptions were made by the task force:

- Early retirees were at salary step 15 within their pay grades.
- Replacement employees would be hired at salary step five.
- Of the affected positions, 37 percent would be general fund positions.
- Early retirements would be effective on or about October 1, 1991.

The only significant effect of the legislative process upon the administration's proposal was to increase the amount of savings expected to result from the early retirement incentive program. As approved by the General Assembly, the required cost savings for FY 1992 was $37.1 million. This requirement was contained in the Appropriations Act for FY 1992. The cost savings were to be accomplished through a target reduction in the maximum employment level (MEL) of 1,080 positions. Most of the savings were to come from non-general funds ($22.9 million) as compared to general funds ($14.2 million). The program as originally proposed by the task force, in terms of eligibility requirements and retirement incentives, was not changed by the General Assembly.

EARLY RETIREMENT INCENTIVE PROGRAM IMPLEMENTATION

The early retirement program approved by the General Assembly established a 90-day period, beginning July 1, 1991, during which eligible employees could retire. DPB established an overall implementation plan for the program. One of the major components of the implementation plan was that each State agency had to submit an early retirement plan to its cabinet secretary and to DPB. The cabinet secretaries and DPB also assigned mandatory savings targets to each State agency. VRS' responsibilities included providing information to employers and eligible employees, and processing early retirement applications. VRS was also responsible for providing cost estimates, and final program cost data, to political subdivisions. This section will discuss the major elements involved with implementation of the early retirement program.

Implementation Plan Developed by DPB

DPB played a major role in preparing an implementation plan for the program. According to the plan, DPB developed early retirement program instructions for the agencies. Following these instructions, each agency developed an early retirement plan for submission to DPB and the appropriate cabinet secretary. The development of agency instructions and early retirement plans, and review of the early retirement plans, took place during the spring and summer of 1991. During the fall, actual program results were supposed to be monitored, with mandatory savings targets adjusted as necessary.

The final component of the implementation plan was to be a December 1 report from the Secretary of Administration to the Governor evaluating the program. Based on JLARC staff interviews with DPB, VRS, and the House Appropriations Committee staff, it does not appear that any written report was submitted. None of these agencies, each of whom were thoroughly involved in developing and administering the early retirement program, have a copy of any final report on the early retirement program.

Mandatory Savings Targets Established for Agencies

In order to achieve the cost savings required by the Appropriations Act, DPB worked with each cabinet secretary to develop mandatory savings targets for each secretariat and State agency. The targets were established based on the number of early retirements anticipated within each secretariat and each agency. For example, the Virginia Department of Transportation (VDOT), which was expected to have the single largest number of early retirees, was responsible for almost one-third of the entire $37 million savings target.

Table 2 lists the mandatory savings targets established for each of the six State agencies selected by JLARC staff for use as case studies. The targets established for these six agencies accounted for approximately 60 percent of the total mandated savings amount.

Agency Early Retirement Plans Submitted to Secretaries and DPB

In order to ensure that each agency would meet its mandatory savings target, early retirement plans were required. Each agency was required to estimate the number of its employees who would retire early. In addition, each agency was required to identify the number of early retirees who would need to be replaced immediately and those who would need to be replaced after January 1, 1992. Agencies were required to provide supporting documentation justifying their requests for replacing early retirees. In addition, the agency was required to identify the number of early retirees who did not need to be replaced. Finally, agencies were required to specify how they would achieve their mandatory early retirement savings targets. Agency early retirement plans were submitted in June 1991.

Table 2: Mandatory Early Retirement Savings Targets for Selected State Agencies

State Agency	Total Savings Target	Non-General Fund Savings Target	General Fund Savings Target
VDOT	$13,860,000	$13,860,000	$0
DMHMRSAS	$2,593,027	$43,168	$2,549,859
DOH	$2,093,041	$783,325	$1,309,716
DOC	$704,786	$91,889	$612,897
ABC	$2,235,300	$2,235,300	$0
DMV	$1,042,067	$1,042,067	$0
Totals	$22,546,221	$18,055,749	$4,472,472

Source: Department of Planning and Budget.

According to DPB staff, many of the agency early retirement plans contained requests to immediately replace a large percentage of the early retirees. Therefore, early in the process of reviewing the plans, it appeared likely to DPB staff that the 50 percent replacement rate would be exceeded. Table 3 presents summary data from the early retirement plans of the six case study State agencies.

Position Replacement Policy Sought to Minimize Replacements

According to DPB, the development of a replacement policy would be approached in two phases. First, key positions to be refilled would be identified. In addition, the ability to meet budgeted savings through early retirements would be assessed. Second, actual program experience would be assessed and replacement decisions finalized.

The retiree replacement policy of the early retirement program sought to minimize the amount of replacements, while allowing replacements for key employees and for employees delivering essential services. Agencies had to request authority from their cabinet secretary prior to refilling any position vacated by an early retiree. However, while it had been assumed in the cost/benefit analysis that no more than 50 percent of the early retirement positions would be replaced, there was no mechanism for preventing the replacement rate from exceeding 50 percent. Consequently, the rate of retiree replacement could vary by secretariat and by agency.

In order to accommodate agency staffing requirements while also ensuring that mandatory savings targets were met, agencies were sometimes authorized to refill a position vacated by an early retiree if the agency gave up another previously vacant position. To the extent that this occurred, actual savings in personnel costs due to the early retirement program were reduced.

Table 3: Early Retirement Plan Data for Selected State Agencies: Planned Requests for Replacement of Early Retirees

Agency	*Eligible Employees Who Plan to Retire Early*	*Percentage to Replace Immediately*	*Percentage To Replace After January 1,1992*	*Total Percentage To Replace*	*Percentage Not to Be Replaced*
VDOT	1076	22%	45%	67%	34%
DMHMRSAS	326	94%	4%	98%	2%
DOH	132	36%	55%	91%	9%
DOC	157	73%	24%	97%	4%
ABC	119	67%	3%	70%	30%
DMV	66	49%	21%	70%	30%
Totals	1880	43%	33%	76%	24%

Note: Some percentages do not total to 100 due to rounding.

Source: JLARC staff analysis of agency early retirement plans.

VRS Responsibilities for Early Retirement Administration

VRS had numerous responsibilities for administering the early retirement program. First, VRS had to advise employers and employees within the retirement system of the provisions of the program. This was done through special publications distributed to all employees and employers. These publications included instructions for submitting applications, benefit calculation instructions, sample resolutions for school boards and political subdivisions concerning authority to participate in the program, and a set of questions and answers for school districts and political subdivisions. VRS also used special meetings, interactive video conferences, and television call-in programs to advise employers and employees concerning the early retirement program.

VRS was also responsible for calculating estimates of the cost of the early retirement program for political subdivisions. This was done with the assistance of the VRS actuary. The cost estimates for all political subdivisions, with the exception of local school boards, were in the form of an addition to the employer contribution rate. The political subdivisions were provided with two contribution rate increase estimates. The first assumed 100 percent participation among eligible employees. The second assumed 50 percent participation.

Cost estimates for local school boards had to be performed differently. Since there is just one blended employer contribution rate for teachers, regardless of the school board for which they work, cost estimates for local school boards were in the form of a lump sum dollar amount. VRS provided each local school board with a range of estimates. First, it provided each school board with the lump sum cost for 100 and 50 percent participation, along with the monthly cost for each assuming a 20-year repayment schedule at eight percent interest. VRS then provided each school board with the cost of a 30 year repayment for both 100 and 50 percent participation rates. These costs were provided both as level monthly payments, and as payments increasing by four percent annually. Final cost letters sent to each local school board provided costs based on ten, 20, and 30 year repayment periods. Upon receipt of the final cost letters, school boards were required to commit to a specific repayment schedule.

Finally, VRS had to review and process all of the applications for early retirement that were submitted. Unlike the workload normally associated with service retirement applications, the early retirement program resulted in a large amount of applications received within a relatively short period of time. However, according to VRS management, VRS was able to handle the increased workload without having to hire additional staff.

STATE AGENCY AND LOCALITY EXPERIENCE WITH THE PROGRAM

The early retirement program created advantages and disadvantages for State agencies. On one hand, it provided the opportunity for a dignified exit by some long-time employees who were no longer as productive or proficient as they had once been. For these employees, the incentive program was a tremendous benefit. On the other hand, the program resulted in a sudden and massive loss of valuable employees, many with irreplaceable technical and managerial expertise. This contrast in advantages and disadvantages was due to the fact that the early retirement program was mandatory for all State agencies. Any employee, regardless of skill and performance, could retire if they met the eligibility criteria. It was the responsibility of each agency to cope with any adverse effects that might arise as a result of the program.

The early retirement program was optional for political subdivisions and school boards. Consequently, the political subdivisions and school boards could evaluate their unique situations and decide whether participation in early retirement program was in their best financial and programmatic interests.

Experience of Selected State Agencies

As previously stated, a major assumption underlying the early retirement program was that only 50 percent of the retirees would subsequently be replaced. It is not clear whether this assumed replacement rate was actually achieved. The six State agencies examined by JLARC staff together accounted for approximately 53 percent of all of the early retirements among State employees. While retiree replacement rates varied, five of the six agencies replaced well over 50 percent of their early retirees (Table 4).

State agencies had positive and negative experiences with the early retirement program. For example, while the program allowed certain long-time employees who were not receptive to administrative and policy changes to depart under dignified circumstances, the program also created a significant loss of talent and expertise in many agencies. Consequently, some agencies encountered greater administrative and operational difficulties as a result of the program than did others.

> *According to VDOT, it is still recovering from the impact of the early retirement program. It took the agency approximately three years to refill all of the early retiree*

Table 4: Employee Participation and Retiree Replacement Among Selected State Agencies

Agency	*Number of Early Retirees*	*Participation Percentage*	*Number of Replacements*	*Replacement Percentage*
VDOT	952	60%	570	60%
DMHMRSAS	413	82%	291	70%
DOH	158	66%	128	81%
DOC	142	75%	106	75%
ABC	135	81%	95	70%
DMV	70	71%	23	33%
Totals	1,870	68%	1,213	65%

Source: JLARC staff analysis of agency early retirement data.

vacancies that it was authorized to replace. VDOT management cited several adverse affects from the program. First, an increase in the number of employee grievances was attributed to the hiring of new, relatively inexperienced managers to replace early retirees. Second, the administrative burden to determine who could and would retiree early, what the impact would be and how it could be minimized, and to identify critical positions, was enormous. Third, there was a quick, mass exodus of many key employees who had been in positions of authority.

VDOT management said that there was some initial confusion concerning the retiree replacement policy. At first, VDOT was told that it could not replace any of the early retirees. Subsequently, VDOT was informed that it could replace retiree positions provided that the agency eliminated a previously vacant position.

VDOT management also recognized the benefits of the program. Many younger people with a more team-based approach to management improved the agency's work environment. It also provided many opportunities to bring new ideas and a fresh perspective into the agency.

Other agencies, while acknowledging that early retirement was a tremendous benefit for eligible employees, expressed concern about certain planning and implementation aspects of the incentive program.

According to DOH management, the early retirement program was very good from the perspective of agency employees. On balance, the program did not seriously affect the ability of the agency to perform its mission. While there were some delays in providing services, services were still provided.

However, according to DOH, the retiree replacement approval process conducted by the Secretary of Health and Human Resources was too slow. This process should be improved and expedited in the event of another early retirement program. For example, instructions to agencies on replacement request procedures should be issued much earlier, preferably before the window period begins. This would enable agencies to minimize vacancy periods for critical positions. DOH management also believes that State agencies should keep better data and statistics concerning early retirements.

* * *

According to DMHMRSAS staff, the entire early retirement program was poorly planned. This was probably due to a lack of time. If there is to be another early retirement program, the State needs to do a better job up front in providing guidance concerning the replacement of retirees. "People forget that we are a 24 hour a day operation." Some DMHMRSAS staff do not think that the State saved any money from the early retirement program. The agency's cost to administer the program was a big expense.

Other DMHMRSAS staff noted that the impact of the program on agency management and leadership had been underestimated. A tremendous amount of experience was lost all at once. On the other hand, the program provided a graceful exit to a number of long-time employees who were not entirely receptive to changes that were under way throughout the agency.

One agency questioned the validity of a the 50 percent retiree replacement assumption used by State to estimate the costs and benefits of the program.

> *According to DOC staff, the 50 percent replacement assumption was "ridiculous." It effectively assumes that half of the individuals who retire early are employed in nonessential positions. However, the agency had to achieve this assumption in order to reach its mandatory savings target. DOC does not believe that much "deadwood" left the agency as a result of the early retirement program.*

According to DPB, long-term savings from early retirement were possible only through elimination of a majority of the early retiree positions. However, State agencies used a number of approaches, in addition to position elimination, in order to achieve their mandatory budget savings targets for fiscal year 1992. For example, while a portion of the required savings was realized through elimination of positions, delayed replacement of early retiree positions provided an additional source of savings. Some other approaches to budget reduction, not directly related to the elimination of positions, were also used.

> *The Department of Health's mandatory budget reduction target was $2,093,041. Twenty-four percent of this amount was achieved through the elimination of 18 early retiree positions. However, 76 percent of the total reduction target was achieved through a reduction in the agency's uncommitted year end balance from fiscal year 1991.*
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> *The Department of Motor Vehicles' mandatory budget reduction target was $1,042,067. Sixty-three percent of this amount was obtained through the elimination of 24 early retiree positions. Thirty-seven percent of the required savings was achieved through delays, of between one and six months, in the refilling of 56 early retiree positions.*

Experience of Selected Local School Boards

Participation in the early retirement incentive program was optional for political subdivisions and school boards. Unlike the State, the school boards reviewed by JLARC staff did not attempt to generate permanent savings by eliminating positions. Due primarily to mandatory student/teacher ratios, and since virtually all of their early retirees were teachers, the ten local school boards examined by JLARC staff replaced most of their early retirees. In fact, five of the ten school boards replaced more than 90 percent of their early retirees.

The experience of school boards was similar to that of the State in one respect. The early retirement program provided a dignified exit for certain long-time employees, many of whom were no longer receptive to change. The program also provided an opportunity to hire younger, and often more technically-oriented individuals, at a lower salary.

Under the terms of the repayment agreement with VRS, the local school boards' first required payments to the retirement system are due by the close of fiscal year 1995. Therefore, the costs of the early retirement program are only now beginning to be felt by the political subdivisions. Table 5 summarizes the employee participation and retiree replacement rates for each of the ten political subdivisions, and also indicates the cost of the early retirement program to the political subdivisions.

The local school boards examined by JLARC staff appear to have taken a careful, thorough approach to considering the costs and benefits prior to deciding whether to participate in the early retirement program. For example:

> *The Chesapeake School Board estimated that it would save approximately $8 million, due to lower personal services costs, over a six year period beginning in FY 1992. After six years, the school board assumed that the early retirees would have retired normally. The school board considered this savings within the context of $12 million in additional pension liability payable to VRS over 20 years. However, the school board estimated that its net pension liability could be decreased by $3 million. This will be done by making the annual payment to VRS at the beginning, rather than the end, of the fiscal year.*
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> *The Prince William County School Board estimates that, over the long term, the costs and benefits of the early retirement program will be equal. However, had the school board not changed its policy for paying out annual and sick leave balances to the early retirees, the long-term costs of early retirement would have exceeded the long-term benefits. Normally, the school board gives retirees the choice of either converting their annual and sick leave balances into leave which is taken prior to the effective date of retirement, or taking a lump sum cash payment. Generally, converted leave is more*

Table 5: Early Retiree Replacement, Cost Savings, and Additional Pension Liability of Selected School Boards

Local School Board	*Number of Early Retirees*	*Participation Rate*	*Early Retiree Replacement Percentage*	*Liability to VRS as of 6/30/94*
Newport News	144	80%	96%	$14,290,108
Portsmouth	139	70%	91%	$11,079,331
Chesapeake	138	57%	83%	$9,911,549
Hampton	129	73%	94%	$12,293,004
Prince William County	120	67%	99%	$12,200,861
Lynchburg	73	73%	83%	$6,807,355
Rockingham County	63	76%	91%	$5,911,307
Washington County	62	76%	81%	$4,148,097
Buchanan County	59	75%	53%	$4,075,685
Tazewell County	59	79%	59%	$4,533,342

Source: JLARC staff analysis of data from VRS and school boards.

valuable than a lump sum payment, since the lump sum is calculated using reduced salary rates. However, participants in the 1991 early retirement program were not given that option. Individuals had to take a lump sum payment from the school board in order to participate in the early retirement program.

Management at some of the local school boards examined by JLARC staff raised additional issues relating to the early retirement program. These included the terms of the repayment arrangement with VRS, and the ability of the local school boards to actually repay their long-term liability to VRS. The option of school boards to repay VRS in a lump sum was apparently the source of some confusion. While VRS states that lump sum repayment was always an option, and was in fact the preferred option, one school board examined by JLARC staff did not have that understanding.

The Lynchburg School Board would have liked a lump sum option for repaying VRS. The school board discussed with the City of Lynchburg the possibility of raising money through the public bond market to finance a lump sum payment to VRS. The school board believes that it could have obtained debt financing at an interest rate of no more than four percent. However, according to the school board, a lump sum repayment to VRS was never an option. Lynchburg is repaying its liability over 20 years at an eight percent interest rate.

According to management of the Lynchburg School Board, other school systems throughout the State are not sure that they will be able to repay VRS. Some have apparently expressed the hope that, in time, the State will bail them out of their obligation to VRS.

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Although the Chesapeake School Board decided to offer the early retirement program to its employees, the City of Chesapeake did not elect to participate in the program. The school board's decision has created a long-term financial liability. However, since the school board is ultimately dependent on the city council for its funding, there is potential for disputes between the city and the school board concerning continued funding to meet the early retirement liability.

Program Created Large Actuarial Loss for VRS

In preparing the June 30, 1990 actuarial valuation, an early retirement incentive program was not foreseen by the VRS actuary. Consequently, a significantly greater number of individuals retired during 1990-92 than had been assumed by the actuary. As a result, the early retirement incentive program created a $238.2 million actuarial loss for VRS due to the participation of State employees in the program. This loss, which was reported in the 1990-92 actuarial experience study, constitutes an additional liability which was not immediately offset by additional contributions to the system. VRS has not calculated the impact, if any, that the cost of the early retirement program had on the required employer contribution rate.

There were also actuarial losses for political subdivisions and local school boards. Losses for the school boards totaled $119 million. These losses are reflected in the repayment schedules of each school board. Actuarial losses for political subdivisions are reflected in their respective employer contribution rates.

EARLY RETIREMENT INCENTIVE ISSUES FOR LEGISLATIVE CONSIDERATION

Virginia is one of many states which have offered early retirement incentive programs in recent years. These state programs have varied significantly in terms of their objectives, designs, and results. The experiences of Virginia's State agencies and political subdivisions with the 1991 program, together with the experiences of other states, raise a number of important issues. These issues should be thoroughly and explicitly considered in determining whether, and under what conditions, another early retirement incentive program should be authorized.

Short-Term Budget Reductions and Long-Term Pension Liability

There are tradeoffs associated with an early retirement program. Personnel costs can be reduced, in the short term, provided that a majority of the vacated positions are not filled and provided that the remaining positions are refilled at a lower salary. However, savings from lower personnel costs should be possible to achieve within a few years even without an early retirement incentive program, since all early retirees would eventually retire under normal circumstances. At that point, they can be replaced with individuals receiving lower compensation.

As a result of Virginia's early retirement program, State agencies were able to replace higher compensated employees for lower compensated employees a few years sooner than they otherwise could have. However, the tradeoff for that accelerated reduction in personnel costs is a long-term increase in pension expenses. Furthermore, as DPB's analysis indicated, an early retirement program can create a net financial loss for the state if the position replacement rate is sufficiently large. A 1992 report by the National Association of State Budget Officers summarized this concept.

> Successful plans, in a budgetary sense, require discipline on the hiring side. Without such discipline and without a long-term focus, States could find themselves refilling the majority of positions after funding generous retirement incentives.

Relationship with Overall Budget Reduction Strategy

Early retirement should be available as a tool to assist State agencies in meeting an overall budget reduction goal. In this way, agencies can determine which positions can be eliminated in order to achieve the reduction target. Employees in those positions could then be offered early retirement rather than being laid off. However, the State did not utilize early retirement in this manner. Rather, the State planned to achieve budget reductions through the elimination of specific early retiree positions. Staff from several State agencies expressed concern regarding this issue.

> *VDOT would prefer that any future early retirement program not be tied directly to a reduction in employment levels. VDOT management does not object to a requirement that it eliminate a certain number of positions. However, it would like the flexibility to decide which positions will be eliminated in order to meet an overall target. VDOT does not want to be forced to eliminate a position held by an early retiree, nor does it want to be prohibited from refilling specific positions.*
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> *DMHMRSAS management characterized the early retirement program as an "all or nothing, unilaterally imposed program." In the future, agency management should be given a menu of different options, such as severance pay, as part of the effort to rightsize State government.*
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> *DOC management would favor an optional early retirement program for State agencies that is closely integrated with budget reduction plans. Such a program would enable agencies to offer early retirement to employees affected by budget reduction decisions.*

Monitoring and Evaluation of Participation and Replacement

In order to determine the extent to which planned rates of employee participation and retire replacement are being realized, systematic monitoring and record keeping is essential. However, subsequent to October 1991, there does not appear to have been any comprehensive review of retiree replacement or of any other results of the program. A planned report to the Governor in December 1991 apparently was not made, at least not in writing. Consequently, the availability of comprehensive data concerning replacement of early retirees is sketchy and incomplete. The best available position replacement data is from the agencies themselves, as opposed to a central State agency such as DPB.

Following the close of the early retirement window on September 30, 1991, the Administration reported the results of the program as they were known at that time. The General Assembly was informed that 3,190 State employees had retired early. Immediate replacement was authorized for 1,044 of those positions. Policy decisions still had to be made concerning the replacement of 2,146 positions. However, 908 of the 2,146 positions were specifically exempted from the need for future decisions. These were faculty, human affairs and institutional services, engineering, applied science and technology, and law enforcement positions located within the education, transportation, human resources, and public safety secretariats. These 908 positions were all, in effect, authorized for immediate replacement. Table 6 summarizes the information provided to the General Assembly in October 1991.

Overall, taking into consideration positions authorized for immediate replacement and positions exempted from the need for future replacement decisions, 1,238 early retirement positions were still in need of replacement decisions as of October 18, 1991. However, actual monitoring of subsequent replacement decisions for the 1,238 positions was not conducted at the central State agency level. For that reason neither a reliable count of refilled State positions, nor a reliable estimate of the total retiree replacement rate, is available.

Some estimates of the overall replacement rate are possible. For example, assuming that none of the 1,238 vacant State positions awaiting policy decisions as of October 16, 1991 were refilled, the total authorized replacement rate for State employees would have been 61 percent (1,952 / 3,190). On the other hand, assuming that half of the 1,238 positions were refilled, the total replacement rate would have been 81 percent ((1,952+619) / 3,190).

According to House Appropriations Committee staff, the 1,238 State positions still requiring replacement decisions in October 1991 were all eventually eliminated. Given the lack of systematic position replacement data, it is not possible to verify that figure. However, according to the 1991 and 1992 Appropriations Acts, the State's maximum employment level (MEL) decreased by 2,184 positions over that two-year period. That lends some support to the belief that many State positions, including early retiree positions, were eliminated.

On the other hand, the number of authorized State positions subsequently increased by 3,915 as a result of the 1993 and 1994 Appropriations Acts (Table 7). In addition, replacement rates for five of JLARC's six case study agencies, which comprised more than half of all the early retirees, were well in excess of 50 percent. That lends some support to the position that the rate of early retiree replacement was significantly higher than the 50 percent that had been assumed.

Due to the availability of actual eligibility and retirement data from VRS, monitoring of participation rates on the part of eligible employees was easier to perform. In October 1991, the Administration reported the following participation rates for eligible employees:

- State employees: 60.3 percent,
- teachers: 69.6 percent, and
- political subdivision employees: 50.7 percent.

Based on JLARC's analysis of final VRS early retirement data, the actual participation rates for State employees, teachers and political subdivision employees were significantly larger than originally reported. The actual participation rates were as follows:

- State employees: 67 percent,
- teachers: 72 percent, and
- political subdivision employees: 64 percent.

Table 6: Replacement Percentage for State Employees Who Participated in Early Retirement Program

Number of Retirees	3,190
(minus) Number Specifically Authorized for Immediate Replacement	- 1,044
(minus) Number of Positions Exempt from Elimination	- 908
(equals) Total Effectively Authorized for Immediate Replacement	= 1,952
Total Authorized Replacement Percentage	1,952 / 3,190 = 61 Percent
Number of Positions Still Requiring Replacement Decisions	1,238

Note: Calculations based on data available as of October 18, 1991. Retirees from Legislative and Judicial branches and independent agencies were not included in the total number of early retirees. In addition, not all college and university faculty who participated in the program were included in the total number of early retirees.

Source: JLARC staff analysis of documentation provided by VRS, DPB and HAC.

Table 7: Authorized State Employment Levels

Year	MEL	Grand Total of Positions	Annual Change in MEL	Annual Change in Grand Total of Positions
1988	96,411	99,670	N/A	N/A
1989	99,624	102,969	+3,213	+3,298
1990	102,794	106,652	+3,170	+3,683
1991	101,948	105,841	-846	-811
1992	100,610	104,599	-1,338	-1,242
1993	101,371	105,517	+761	+918
1994	N/A	108,515	N/A	+2,997

Note: MEL is not specified in the 1994 Appropriations Act. The only term specified is Grand Total of Positions.

Source: 1988 - 1994 Appropriations Acts.

Rehiring of Early Retirees as Part-Time Employees

In order to ensure that mandatory savings targets were achieved, agencies were delayed or prohibited from filling certain early retiree positions. However, these positions were often essential to performance of the agency's mission. This contributed to the need for some agencies to rehire early retirees as temporary or contract employees.

The potential need for agencies to rehire early retirees into their former positions was envisioned by the early retirement program's implementation plan. The Secretary of Finance and the Secretary of Administration stated in writing that an early retiree could be continued in a temporary hourly capacity if the position is determined to be critical, if funds other than the retiree's salary are available, and if the Secretary approved the rehire. However, there apparently was some confusion and misunderstanding within both the legislative and executive branches concerning whether, and under what circumstances, retirees could be rehired as temporary employees. Table 8 provides a chronology of how the rehiring policy evolved at the secretarial level, and how the policy changes were communicated within one particular agency, the Department of Health.

State agencies were not allowed to factor the cost of temporary employees into their early retirement plans and into the achievement of their mandatory savings targets. As a result, actual savings from the early retirement program were overstated by the amount of compensation paid to the rehired early retirees. The extent to which agencies rehired early retirees as temporary, part-time workers varied. However, some agencies made extensive use of this practice. For example:

> *The Department of Mental Health, Mental Retardation and Substance Abuse Services paid $1.2 million in compensation to 76 rehired early retirees. This represented 18 percent of the agency's early retirees. In addition, DMHMRSAS retained the services of one early retiree on a contract basis. This individual was paid a total of $189,540. The $1.3 million in compensation paid by DMHMRSAS to these individuals was more than half of the agency's mandatory savings target of $2.5 million.*
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> *The Department of Alcoholic Beverage Control has paid $678,000 to 58 early retirees, or 43 percent of all its early retirees, who were rehired as temporary employees. This compensation represents 30 percent of the agency's mandatory savings target of $2.2 million.*
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> *Currently 33 of those 58 early retirees, or 24 percent of the agency's early retirees, are still employed by ABC as hourly workers. These individuals are all employed in ABC stores.*

According to these agencies, a number of factors combined to make extensive rehiring of early retirees unavoidable. These included a sudden departure of key staff, the inability to hire replacements in advance or immediately after retirement, and a continuing responsibility to provide services. While this may be true, it also points out weaknesses in the overall design of the early retirement program. In a 1994 report, the Texas State Pension Review Board commented on this type of problem.

> A rash of hiring following an early retirement incentive program is usually an indication that the program either cut too deeply or cut the wrong people. Unless rehires are carefully monitored or restricted, the cost-cutting goals become virtually impossible to achieve.

Table 8: Chronology of the Development and Communication of Administrative Policy Concerning Rehiring of Early Retirees

Memo Date	*Memo Author*	*Policy Statement*
5/16/91	Secretary of Finance/ Secretary of Administration	Any retiree can be continued in a temporary hourly capacity if a position is determined to be critical, if funds other than the retiree's salary are available, and if approved by the Secretary.
7/31/91	Secretary of Administration	Agencies may rehire employees who retire for a period not to exceed 480 hours during which time the agency must be actively recruiting to refill the position with a permanent replacement; extensions to the 480-hour limitation may be approved by the Secretary for exceptional circumstances.
9/17/91	State Health Commissioner	Local health districts can not hire a retiree for more than 480 hours regardless of the position that the retiree will occupy. The 480-hour limitation applies to the retiree and not to the position being vacated by early retirement.
9/18/91	Secretary of Administration	Existing guidelines specify that the 480-hour limitation applies to employees returning to the same position and function. These guidelines should be interpreted to apply to positions that are comparable in a very strict sense to the vacated covered position. The point here is that the guidelines do not refer literally to the same covered VRS position, since if they did the person could not receive a retirement benefit.
10/9/91	State Health Commissioner	Guidance received on 10/4/91 relaxes the rules a bit regarding the rehire of retirees. The application of rules depends upon the duties and responsibilities of the hourly paid position. If the duties are the same or similar the approval of the Secretary is required and the individual is limited to 480 hours without an approved exception.

Source: JLARC staff analysis of documentation provided by Department of Health.

Given the prohibition or forced delay in refilling key positions, and given continuing service and workload requirements, many early retirees wound up receiving wage compensation in addition to their enhanced retirement benefits. This situation raises questions of equity that the General Assembly may wish to consider.

Recognition of All Program Costs

In addition to the additional pension liability costs created by an early retirement program, the early retirement program also created other costs. These costs, which agencies could not factor into the achievement of their mandatory savings targets, included compensation paid to early retirees who were rehired as temporary employees or contract employees. They also included costs related to recruitment of full time replacements for the early retirees. This included direct costs for things such as position advertisement, as well as indirect costs pertaining to the amount of agency staff time devoted to the recruitment process. According to VDOT management:

> The rippling effect of the promotions through the organization and the costs for advertising and filling the positions that were allowed to be refilled will never be known. And there were countless hours of counseling potential retirees and trying to help them decide even though they had no time to plan for it.

Instructions concerning the development of early retirement plans specifically prohibited State agencies from recognizing certain of these costs in the development of their plans. Refusal to in some way recognize such costs results in an overstatement of the net benefits of the program.

Use of the Retirement System to Solve Agency Personnel Problems

One of the stated objectives of the early retirement program was to provide an alternative to employee layoffs. Several agencies interviewed by JLARC indicated that the early retirement program provided a dignified way out for unproductive or problem employees that the agency had been unable to let go. While this can be viewed as a benefit of the program, some individuals interviewed by JLARC staff questioned the merits of such an approach. According to these individuals, the early retirement program was used to perform a function that perhaps could be performed more appropriately, and inexpensively, through the State personnel system.

> *ABC management believes that a sound State personnel policy would have accomplished the objectives of the early retirement program but at a lower cost. For example, the State should eliminate employee "bumping" rights in the event of layoffs. In addition, the State should institute a "bottom five" policy in which the bottom five percent of agency employees, in terms of performance, are terminated each year. This would prevent poor performers from remaining in the agency for too long. The State should also establish a severance pay plan.*

CONCLUSION

The 1991 early retirement incentive program enabled the State to reduce personal services expenses by $37 million in FY 1992. However, this savings was obtained at the cost of an additional $238 million in VRS pension liability. According to the stated rationale for the program, long-term reductions in personal services costs would exceed long-term additions to pension liability. However, given incomplete early retiree position replacement data, is difficult to evaluate the veracity of this rationale. In particular, it is difficult to test the accuracy of the assumption that 50 percent of all State early retiree positions would be eliminated.

Conflicting evidence suggests the possibility of either elimination or refilling of a majority of the early retiree positions. The number of authorized State positions declined significantly in the year following the early retirement program. However, based on the experience of six large State agencies examined by JLARC staff, and given the recent large increases in authorized State positions, it appears possible that a vast majority of early retiree positions were eventually refilled. Therefore, it is highly questionable whether the early retirement program will result in any net savings to the State over the long-term.

In the event that the General Assembly considers authorizing a new early retirement incentive program, it may wish to consider the key issues discussed in this report. These issues include the early retirement program's proper relationship with the State's overall budget reduction strategy, and the need to adequately evaluate and document program results. The General Assembly may wish to consider establishing specific program requirements in order to incorporate recognition of these issues during planning and implementation of an early retirement program.