Report of the
Joint Legislative Audit and Review Commission
To the Governor and
The General Assembly of Virginia

Review of State Employee Total Compensation

In Brief

Review of State Employee Total Compensation

The Joint Legislative Audit and Review Commission (JLARC) approved a resolution in November 2006 for its staff to study compensation for employees of the Commonwealth. To assist with the review, JLARC staff procured analytical and consulting support from PricewaterhouseCoopers (PwC) and Mercer.

The study found that most agencies that employ classified staff agreed that total compensation allows them to attract sufficiently qualified staff. Employees reported that the State's health insurance, retirement, and leave benefits are among the most effective recruitment and retention tools.

Mercer found that the State's total compensation was 96 percent of the market median. Cash compensation was 88 percent, while benefits were 108 percent of the market median.

JLARC staff have identified two total compensation options for further consideration by the General Assembly. In the fifth year of implementation, the first option would result in approximately $82 million in cost avoidance. The second option would result in approximately $1 million in cost avoidance in the fifth year, but is designed to achieve greater savings in the long-term.

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COMMONWEALTH of VIRGINIA

Joint Legislative Audit and Review Commission

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December 15, 2008

The Honorable M. Kirkland Cox
Chairman
Joint Legislative Audit and Review Commission
General Assembly Building
Richmond, VA 23219

Dear Delegate Cox:

In November 2006, the Joint Legislative Audit and Review Commission directed staff to study compensation for employees of the Commonwealth. Staff were specifically directed to review a range of issues related to employee total compensation, including the adequacy of salaries and benefits and how State employee total compensation compared to that provided by other public and private employers. Findings of the study were presented to the Commission on October 14, 2008.

On behalf of the Commission staff, I would like to thank the Department of Human Resource Management and Virginia Retirement System staff for their assistance during this study. I would also like to thank the many agency human resources staff and employees who participated in interviews and surveys. Finally, I would like to acknowledge the efforts of Mercer and PricewaterhouseCoopers, the two private consulting firms that assisted us during the review.

Sincerely,

Philip A. Leone
Director

PAL/jcb

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JLARC Report Summary:
Review of Total Compensation for State Employees

Key Findings

- Eighty-one percent of agencies that employ classified staff agreed total compensation allows them to attract staff that are sufficiently qualified. Overall, the State's total compensation is 96 percent of the market median. (Chapter 2)
- The State should develop a total compensation strategy and create an advisory council to facilitate more integrated and analytic decision-making about salaries and benefits. (Chapter 2)
- Despite the fact that salary is the largest single element among total compensation spending and the most important element to employees, it is at best partially effective at recruiting, retaining, and motivating State employees. Total cash compensation, which includes salaries and bonuses, is 88 percent of the market median. (Chapter 3)
- Health insurance, retirement, and leave benefits are among the State's most effective recruiting and retention tools. Total benefits are 108 percent of the market. The historical and projected rate of spending growth for health insurance makes it the highest financial risk area among the elements of compensation. (Chapters 4, 5, and 6)
- In accordance with the study mandate, JLARC staff have identified two total compensation options for further consideration by the General Assembly. Both options involve altering the benefits provided to employees, and redeploying some portion of the cost avoidance towards increased cash compensation for selected employees. In the fifth year of implementation, the first option would result in approximately $82 million in cost avoidance. The second option would result in approximately $1 million in cost avoidance in the fifth year, but is designed to achieve greater savings in the long-term. (Chapter 7)

On November 13, 2006, the Joint Legislative Audit and Review Commission (JLARC) approved a resolution for its staff to study compensation for employees of the Commonwealth. The resolution directs staff to assess the State's current compensation system and identify opportunities to promote recruitment and retention of a qualified workforce, maximize employee productivity, address long-term growth of costs for retirement and other benefits, maximize benefit flexibility and choice for employees, enhance employee job satisfaction, and minimize administrative workload and costs for State agencies.

JLARC staff procured analytical and consulting support from PricewaterhouseCoopers (PwC) and Mercer to assist with this review. These two companies independently compared the State's salaries and benefits to what other employers provide and conducted an assessment and made recommendations regarding the current approach.

The State compensates its employees through salaries and a comprehensive benefits package, including health insurance, retirement, and leave. The State primarily provides this compensation so agencies can recruit and retain a sufficient workforce. At the beginning of 2008, the classified State workforce totaled approximately 73,000 employees. In FY 2007, the State spent approximately $5 billion on classified employee salaries and employee benefits. In addition to being a major portion of State spending, employee compensation is also important for effective and efficient agency operations.

TOTAL COMPENSATION ACHIEVES PURPOSES IN MOST CASES, YET FINANCIAL RISK IS CONCERN FOR HEALTH AND RETIREMENT BENEFITS

In 2007, the average turnover rate among classified State employees was 11.5 percent, which compares favorably to the turnover rates of other governments and the private sector. In addition, more than 80 percent of agencies that employ classified staff agreed that the total compensation they offer allows them to attract staff who are sufficiently qualified. Mercer benchmarked the total compensation (salaries and benefits) the State provides at 96 percent of the market median. Total cash compensation was less competitive at 88 percent of the market median. This was somewhat offset by total benefits being more competitive at 108 percent of the market.

Commonwealth Needs a Total Compensation Strategy

The process by which the level of salaries and benefits is considered should be based on an established set of principles and goals. These principles and goals—for example, how the State wishes to define "comparable" to the private sector as described in Section 2.2-1202 of the *Code of Virginia*—should be articulated in a statewide total compensation strategy. Mercer identified total compensation strategies as a best practice, and raised concern that absent a compensation strategy driven by principles and goals, the State has no foundation from which to make decisions about the level of salaries and benefits it provides. Consequently, Mercer suggested that the State develop a total compensation strategy.

Mercer identified total compensation strategies as a best practice …

At a minimum, the strategy should identify key principles and goals by answering some fundamental questions that are highlighted and discussed in more detail throughout this report. Articulating these principles and goals in a strategic document will provide the foundation from which to decide, for example, what proportion of cash compensation and benefits the State wants to provide as part of its total compensation package. The total compensation strategy will need to be continually refined as conditions change, particularly in the broader environment for health insurance. For instance, the impact that salary and benefit changes will have on the State's competitive position will depend, in part, on whether other employers also make changes to their total compensation packages.

The Governor and the General Assembly may wish to direct the development of a total compensation strategy that builds from the current workforce planning approach and is further integrated into the State's strategic planning and budget process. The total compensation strategy should identify principles and goals to assist in managing salaries and benefits. The total compensation strategy should also identify the specific actions the State will undertake to be consistent with and achieve these principles and goals.

Commonwealth Needs a More Integrated and Analytic Approach to Total Compensation Decision-Making

Articulating a total compensation strategy will require an integrated perspective across the elements of compensation and branches of government. Yet, no single organization is currently responsible for taking such a perspective across the various purposes and spending associated with salaries, health insurance, retirement benefits, and leave. As emphasized throughout this report, an integrated perspective is critical to ensuring that the salaries and benefits the State offers achieve their intended purposes—but at a cost which is sustainable and efficient.

Therefore, the General Assembly may wish to create a compensation advisory council, which would consist of the directors of the Department of Human Resource Management (DHRM), Department of Planning and Budget (DPB), the Virginia Retirement System (VRS), the House Appropriations Committee, and the Senate Finance Committee, and the Executive Secretary of the Virginia Supreme Court. The council's role should build upon—rather than duplicate or supplant—the existing knowledge and expertise that reside within DHRM, VRS, DPB, and agency human resource offices. The council should be supported by additional staff resources, likely placed at DHRM and DPB. In addition to supporting the council, these staff should be tasked with providing additional analytical support to agencies that is necessary in certain cases. Depending on the level of expertise an agency human resource office has, this support may include consulting, assistance collecting employee survey data or market data, or guidance in developing budget requests.

The council's primary responsibilities would be to facilitate a comprehensive perspective across the elements of total compensation and branches of government; appropriately consider and balance agency and employee perspectives; and provide analytical rigor and transparency about (1) the supporting, objective facts indicating whether changes to salaries or benefits are necessary, (2) what changes should be made, if any, and (3) what the impact of the changes would be on the purposes of compensation, the State's financial risk, and employee and employer satisfaction. The council would report to the Governor and General Assembly annually on critical issues related to salaries and benefits, as well as provide analysis of the fiscal, operational, and human resource impact of proposed changes to total compensation during each legislative session.

The council could facilitate the development of a total compensation strategy. After the completion of the strategy and its first report, the extent of the council's activities would be largely determined by whether objective analysis indicates strategic changes to salaries and benefits should be considered.

Salary Partially Achieves Its Purposes

Salary is the largest element of compensation in terms of spending and the most important single element to employees. Despite its importance, agencies and employees generally agreed that salaries as currently provided are not the State's most effective recruiting, retention, and motivation tool. In fact, only nine percent of classified employees agreed that salary was the primary reason they work for the State. Mercer found that the base salaries for employees in 43 job roles, on average, ranked at 92 percent of the market median, but competitiveness varies significantly by job role. Salaries paid to about two-thirds of these 43 job roles were competitive with the market median, yet the remaining one-third were paid salaries that, on average, were less than 90 percent of the market.

Health Insurance Benefits Mostly Achieve Purposes Amid Cost Concerns

In contrast, health insurance is among the State's most effective recruiting and retention tools, in part because of its value relative to other employer health plans. However, cost still limits access for some lower income employees, and the limited health management programs only partially encourage healthy and productive employees. State spending on health insurance has grown faster than salaries, total compensation spending, and the ten largest agency appropriations. Total program expense for health benefits (including State and employee costs) was $759 million in FY 2007. Mercer projects that the State's portion of this spending will grow to more than $1.1 billion by 2012 if changes are not made.

Retirement Benefits Mostly Achieve Purposes

The defined benefit retirement plans the State provides are competitive with what other employers offer and achieve their goals of retaining longer-tenured employees and providing an adequate benefit to retire. The majority of recent retirees retired prior to the normal retirement ages of 65 for the regular VRS plan and 60 for the State Police Officers' Retirement System (SPORS) and Virginia Law Officers' Retirement System (VaLORS) plans. When combined with Social Security, these plans replace between 82 and 92 percent of an average employee's pre-retirement income. Since 1990, the VRS Board-certified contribution has only been fully funded eight times. If this trend continues, PwC projects that the funded status of the retirement plans will likely decline in the future.

Leave Benefits Mostly Achieve Purposes

The State's leave benefits are effective recruiting and retention tools for most agencies, in part because they are comparable to what other large employers offer. Leave benefits are also effective, in most cases, at fostering employee productivity, motivation and morale, and work/life balance. However, agencies with 24/7 staffing requirements had concerns about the impact of the leave benefits on productivity, and these agencies' employees were less likely to agree they have sufficient work/life balance. Many employees at these agencies, and others, expressed a preference for additional cash compensation relative to benefits such as leave.

Current Approach May Result in Continued Recruitment and Retention Problems for Certain Agencies and the Risk of Future Benefit Cost Growth

As shown in the table on the following page, the JLARC staff summary assessment of the State's approach to salaries and benefits yields no instances in which the purposes of compensation are not at least partially achieved. Consequently, the General Assembly could continue the current approach to compensation.

If no changes are made, current and prospective employees will continue to view job stability and competitive benefits as the State's primary recruiting and retention tools. However, the challenges that certain agencies are facing in managing the State's workforce will likely worsen. In the near term, agencies experienc-

Summary Assessment of State's Current Approach to Salaries and Benefits

	Purposes						Cost	
	Recruit	*Retain*	*Motivation & Morale*	*Health & Productivity*	*Retire*	*Work/ Life Balance*	*Current $ (millions)*	*Future $ Risk Level*
Salary	◐	◐	◐				$3,301	Low
Health Insurance	●	●		◐			677	High
Retirement Benefits	●	●			●		487	Medium
Leave Benefits	●	●	◐	◐		◐	24	Low

Legend for Scale of Purpose Achieved | ● Mostly | ◐ Partially | ○ Minimally | [Blank] Not Applicable

Source: JLARC staff assessment.

ing recruiting and retention challenges (in particular, Department of Corrections and Department of Mental Health, Mental Retardation and Substance Abuse Services facilities) attributable to salaries will continue to struggle and likely confront greater difficulty as their workforce ages and subsequently retires. Further, agencies that can recruit and retain sufficient staff will likely continue to be confronted with the fact that, in many cases, some of their employees prefer a greater emphasis on cash compensation.

Another critical concern is the cost of health insurance. It is unclear how long the growth of State health insurance spending can be sustained. The exact threshold for making changes is unclear, but the historical and projected rate of spending growth for health insurance, as well as the influence of factors outside the State's direct control, makes health insurance the highest financial risk area among compensation. Finally, there is a historical tendency for the contributions to the VRS retirement plan to be funded at less than the amount actuarially recommended. If this trend continues, the liabilities to pay for the retirement benefits promised to current employees will continue to be pushed onto future generations in the form of higher State contributions, or will have to be offset by higher than assumed investment returns.

STRATEGIC TOTAL COMPENSATION OPTIONS FOR FURTHER CONSIDERATION BY THE GENERAL ASSEMBLY

This report makes recommendations and identifies potential options to change the State's approach to salaries, health insurance, retirement benefits, and leave benefits for classified employees. Due to the comprehensive nature of this review, and in accordance with the study mandate, JLARC staff have identified two total compensation options for consideration by the General Assembly.

Total Compensation Option 1 – Targeted Salary Increases, Moderate Health and Retirement Changes, and Increased Employee Choice

Total compensation option 1 largely centers around adjusting the proportions of total compensation spending to place a slightly higher emphasis on cash compensation and a slightly lower emphasis on benefits. The components of total compensation option 1 and their projected impact on the State's purposes and costs are

Summary Assessment of Potential Impact of Total Compensation Option 1

Option Component	Option Objective	Purposes: *Recruit*	*Retain*	*Motivation & Morale*	*Health & Productivity*	*Retire*	*Work / Life Balance*	Cost: *Projected Annual Cost Impact in Year 5*	*Future $ Risk Level*
Moderate pay for purpose (S1)	Improve recruitment and retention	↑	↑	↔				+$89 million	Higher
Moderate changes to reduce growth of State health spending (H1)	Improve sustainability of health benefits	↔	↔		↔			-$46 million	Lower
Employee contributions into VRS (R1)	Improve sustainability of current level of retirement benefits	↔	↔			↔		*State, SPORS, VaLORS*: -$91 million; *Teacher*: -$42 million	Lower
Reduced COLA (R2)		↔	↔			↔		*State, SPORS, VaLORS*: -$55 million; *Teacher*: -$29 million	
Increase minimum retirement age for new hires and non-vested VRS employees (R3)		↔	↔			↔		TBD based on future hiring	
Exchange unused leave for cash (L1.b)	Increase employee choice	↔	↔	↑	↑		↔	+$21 million	Lower
Projected Total Cost Impact in Year 5 - State Employees Only								**-$82 million**	
Projected Total Cost Impact in Year 5 - Teacher Retirement								**-$71 million (State SOQ) -$180 million (Local)**	

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful | [Blank] Not Applicable

Notes: Annual cost impact figures were derived making various assumptions about the future rate of payroll growth, including performance increases of two percent in FYs 2009 and 2010, three percent in subsequent fiscal years, and a two percent additional increase to fund option S1 in FY 2010. Interaction effect between salary option and retirement options could lead to a $2 million reduction in total cost avoidance shown. Cost impact for health and retirement benefits includes all plan members, not just classified employees. No changes to teacher payroll were assumed. Local cost avoidance for teacher retirement includes non-SOQ staff.

Source: JLARC staff assessment.

summarized in the table. Each of the option components would have either a minimal or beneficial impact on the State's ability to achieve the purposes of salaries and benefits. This is primarily because the moderate options for health insurance and retirement (discussed in Chapters 4 and 5 of the report) have been combined with the option for moderate implementation of the "pay for purpose" approach to providing targeted salary increases and the option to increase employee choice by exchanging unused annual leave for additional cash.

Collectively, these option components would, by the fifth year of implementation, result in approximately $82 million of cost avoidance. Lower incremental cost avoidances will occur prior to that point, but will be determined by the exact implementation timeframe used. All options except for the targeted salary increases lower the future financial risk that confronts the State. If the options to improve sustainability of the current level of retirement benefits are applied to the teachers' retirement plan also administered by VRS, there would be an additional $71 million of cost avoidance for the State in year five and approximately $180 million in cost avoidances for local school divisions.

Total Compensation Option 2 – Targeted Salary Increases, Moderate Health Changes, Alternative Retirement Plan Designs, and Increased Employee Choice

Total compensation option 2 includes more substantial changes to the structure of the retirement system: a combination retirement plan for regular VRS employees and integral part trust (IPT). These changes would apply only to employees not yet vested in VRS and to all newly-hired employees. Therefore, the full fiscal impact of these changes will be realized much less immediately than retirement changes included in total compensation option 1.

The components of total compensation option 2 and their projected impact on the State's purposes and costs are summarized in the table on the following page. As with total compensation option 1, each of the components would have either a minimal or beneficial impact on the State's ability to achieve the purposes of salaries and benefits.

Collectively, in the fifth year of implementation, these option components would result in approximately $1 million in cost avoidance. PwC projected that the combination retirement plan would eventually save 1.94 percent of payroll after 40 years. Savings from this plan would be less prior to year 40, but would gradually increase. For example, by 2027 the annual cost avoidance amounts to $110 million, and by 2047 the annual cost avoidance is projected

Summary Assessment of Potential Impact of Total Compensation Option 2

Option Component	Option Objective	Purposes: Recruit	Retain	Motivation & Morale	Health & Productivity	Retire	Work / Life Balance	Cost: Projected Annual Cost Impact in Year 5	Future $ Risk Level
Moderate pay for purpose (S1)	Targeted salary increases based on business case	↑	↑	↔				+$90 million	Higher
Moderate changes to reduce growth of State health spending (H1)	Improve sustainability of health benefits	↔	↔		↔			-$46 million	Lower
Create new combination plan (R5)	Reduce long-term financial risk and increase employee choice	↔	↔			↔		*State* -$66 million; *Teacher* -$22 million	Lower
Integral Part Trust (R4)		↔	↔			↔			
Exchange unused leave for cash (L1.b)	Increase employee choice	↔	↔	↑	↑		↔	+$21 million	Lower
Projected Total Cost Impact in Year 5 - State Employees Only								**-$1 million**	
Projected Total Cost Impact in Year 5 - Teacher Retirement								**-$22 million (State SOQ)** **-$150 million (Local)**	

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful | [Blank] Not Applicable

Notes: Annual cost impact figures were derived making various assumptions about the future rate of payroll growth, including performance increases of two percent in FYs 2009 and 2010, three percent in subsequent fiscal years, and a two percent additional increase to fund option S1 in FY 2010. Interaction effect between salary option and retirement options could lead to a $1 million reduction in total cost avoidance shown. Cost impact for health and retirement benefits include all plan members, not just classified employees. No changes to teacher payroll were assumed. Local cost avoidance for teacher retirement includes non-SOQ staff.

Source: JLARC staff assessment.

to be as much as $161 million. This cost avoidance would be reduced to some degree by the increased administrative costs of maintaining a second retirement system structure.

The combination plan could also be implemented for non-vested and newly-hired teachers. Placing all non-vested and newly-hired teachers into a combination plan would result in an ultimate cost avoidance of 3.33 percent of payroll. As with the State employee plan, PwC estimates that the cost avoidance would not fully materialize for 40 years and would be somewhat offset by increased administrative costs. In the fifth year of implementation, the cost avoidance from the combination plan if applied to the teachers would be approximately $22 million for the State and approximately $150 million for local school divisions.

Chapter 1

Introduction

In Summary

The State compensates its employees through salaries and a comprehensive benefits package, including health insurance, retirement, and leave. The State primarily provides this compensation so that agencies can recruit and retain a qualified workforce. At the beginning of 2008, the classified State workforce totaled approximately 73,000 employees. These classified employees possess a widely varying set of skills necessary to implement the State's complex and critical programs. In FY 2007, the State spent approximately $5 billion on these salaries and benefits. In addition to being a major portion of State spending, employee compensation is also important for effective and efficient agency operations. Failure to provide salaries and benefits that recruit and retain a sufficient workforce can lead to numerous programmatic challenges and unnecessary expenditures.

The Governor of Virginia has delegated responsibility for employee salaries, health insurance, and leave benefits to the Department of Human Resource Management (DHRM) and State agencies. The Virginia Retirement System (VRS) is responsible for implementing the statutory provisions of employee retirement authorized by the General Assembly. Collectively, the salaries and benefits administered by these organizations resulted in more than $5 billion in State spending in FY 2007.

Management of Salaries and Benefits Decentralized to Agencies

While the Department of Human Resource Management (DHRM) is responsible for statewide human resources management, much of the responsibility to manage salaries and benefits for classified employees lies with executive branch agencies. Agencies are responsible for requesting funding levels and, for example, deciding what each individual employee's salary should be within the policy guidance set forth by DHRM.

On November 13, 2006, the Joint Legislative Audit and Review Commission (JLARC) approved a resolution for its staff to study compensation for employees of the Commonwealth. The resolution directs staff to assess the State's current compensation system and identify opportunities to promote recruitment and retention of a qualified workforce, maximize employee productivity, address long-term growth of costs for retirement and other benefits, maximize benefit flexibility and choice for employees, enhance employee job satisfaction, and minimize administrative workload and costs for State agencies. The study resolution is provided in Appendix A.

During the 2007 and 2008 General Assembly Sessions, additional compensation-related issues were referred to

JLARC for study as part of this review. These issues are identified and addressed in Appendix B.

To address these mandates, JLARC staff procured analytical and consulting support from PricewaterhouseCoopers (PwC) and Mercer, two private companies with extensive experience in human resource consulting and actuarial analysis of employer-provided retirement plans. On behalf of JLARC staff, these companies collected data to benchmark the State's salaries and benefits against what other major employers provide and also independently assessed the State's current approach and made recommendations for change where needed. JLARC staff analyzed existing data about employee salaries and benefits, conducted more than 100 interviews, and administered three major surveys.

STATE COMPENSATES CLASSIFIED EMPLOYEES THROUGH SALARIES AND COMPREHENSIVE BENEFITS

The State provides classified employees with a comprehensive salary and benefits package. A classified employee is covered by the Virginia Personnel Act (Chapter 29, Title 2.2 of the *Code of Virginia*), the State's compensation policies, and other human resource policies. At the beginning of 2008, there were 73,629 classified State employees. The major elements of the compensation package provided to these employees include

- a base salary and opportunities for other cash compensation;
- participation in one of three health insurance plans;
- membership in VRS and participation in the section 457 deferred compensation plan; and
- paid holidays, annual leave, sick leave and disability benefits, and other leave available in specific situations.

Collectively, the salaries and benefits the State provides appear to have six major purposes: (1) recruiting new employees, (2) retaining existing employees, (3) motivating employees to perform and achieve organizational objectives, (4) ensuring that employees are healthy and can be productive, (5) allowing employees to retire at the right time, and (6) allowing employees to maintain an appropriate work/life balance. The various elements of the State's total compensation package are intended to play either a major, partial, or minimal role in achieving these purposes (Table 1).

Table 1: Purposes of State Salaries and Benefits

	(1) Recruit	(2) Retain	(3) Motivation & Morale	(4) Health & Productivity	(5) Retire	(6) Work/ Life Balance
Salary	●	●	●	◐	◐	◐
Health Insurance	●	●	○	●	◐	○
Retirement Benefits	●	●	○	○	●	○
Leave Benefits	●	●	●	●	○	●

Legend | ● Major Role | ◐ Partial Role | ○ Minimal Role

Source: JLARC staff analysis of the *Code of Virginia* and Virginia Retirement System and Department of Human Resource Management documentation.

Salaries and Other Cash Compensation

The most identifiable and significant monetary aspect of compensation is cash provided in the form of salary. The State's salary structure for classified employees is organized into nine pay bands, each with a minimum and maximum salary (except for pay band nine). This salary structure was the result of a compensation reform initiative in 2000. In 2008, the average classified State employee salary was $42,132. Approximately three fourths of all classified employees are in pay bands 2, 3, and 4, which range from a minimum of $20,082 to a maximum of $64,347.

Since 2000, agencies have also had access to flexible pay practices. These flexibilities are used for a variety of purposes, including to provide cash bonuses to help recruit new employees, retain existing employees, or to adjust an employee's salary. More information is provided about salaries and other cash compensation in Chapter 3.

Health Insurance and Related Health Programs

The State offers employees the choice to participate in three health insurance plans: COVA Care, COVA High Deductible Health Plan (HDHP), or Kaiser (a regional HMO plan for those in Northern Virginia). In addition to the basic plan, COVA Care has five options that allow employees to buy expanded coverage at their expense. The three largest options in terms of enrollment are COVA Care Basic; COVA Care Plus Out-of-Network, Vision, Hearing, and Expanded Dental; and COVA Care Plus Vision, Hearing and Expanded Dental. For each plan, employees have the choice of three coverage levels: employee only, employee plus one, or family coverage. Early retirees and their families are also eligible for enrollment.

Overall, the State pays approximately 88 percent of premium costs on behalf of employees. The portion paid by the State varies by coverage level. For basic COVA Care in FY 2009, the State pays $4,932 per year for an employee with single coverage and $12,936 per year for an employee with family coverage. The State's contributions make the health insurance benefit one of the most financially valuable elements of an employee's compensation. Depending on the employee's choice of plan, an employee's portion of the premium ranges from $0 to $936 a year for single coverage, and $0 to $2,820 a year for family coverage.

In addition to offering health insurance to active employees and retirees, the State also provides a number of other health-related benefits to employees, such as a statewide wellness program (CommonHealth), disease management and employee assistance programs (EAP) through the health plans, and medical and dependent care flexible reimbursement accounts. More information is provided about the State's health insurance plans and wellness programs in Chapter 4.

Retirement Benefits

The most important retirement benefit the State provides to employees is participation in a defined benefit retirement plan. The plan guarantees employees who meet the eligibility criteria a regular monthly benefit that is indexed to inflation over the course of their retirement. As of June 30, 2008, the VRS managed retirement plans on behalf of 345,737 currently active employees. Teachers account for about 43 percent of these employees and political subdivision employees account for approximately 30 percent. State employees are the third largest group at just over 80,000, or 23 percent of active members. VRS manages investments to pay retirement benefits to 136,394 retirees and their beneficiaries—for a ratio of roughly 2.5 active employees to each retiree and beneficiary.

The State relies on annual employer-paid contributions and investment returns to finance the cost of the VRS defined benefit retirement plans. For 2008, these contributions are 11.15 percent of salary for regular State employees, and 25.76 percent and 20.86 percent of salary for participants in the two law enforcement retirement plans. These rates are recalculated each biennium based on a variety of assumptions, including the projected number of retirements each year and changes in the number of active employees. The State also pays 6.2 percent of an employee's salary to the federal government for Social Security and another 1.45 percent for Medicare, and contributes 1.18 percent of salary to pre-fund the State's retiree health insurance credit.

The State also offers employees the choice to participate in a deferred compensation retirement plan defined under section 457 of the Internal Revenue Code. This is a defined contribution retirement savings plan in which the benefits paid to a retiree are equivalent to his account balance. As of January 1, 2008, all new employees are automatically enrolled in the 457 plan unless they opt not to participate. The State matches 50 percent of an employee's contributions to the plan, up to $20 per pay period (contributions are placed in a separate 401(a) account).

Once an employee retires, the amount of an employee's retirement benefits is determined by a formula that depends on age at retirement, years of service credit, and average final compensation (AFC). A retiree's AFC is defined as his highest consecutive 36 months of salary. These three factors are multiplied together and then multiplied by the plan's retirement benefit multiplier. For example, the retirement plan for non-law enforcement State employees uses a multiplier of 1.7 percent. The AFC for regular State employees retiring in FY 2007 was approximately $44,000. An employee retiring with this AFC with 30 years of service credit would receive $22,440 per year, or $1,870 per month before taxes, the first year of her retirement. Her benefit would then be adjusted by a cost of living adjustment in the second year after retirement. Beginning as early as age 62, she would then be eligible to receive Social Security payments (reduced for early retirement) that are provided in addition to the VRS benefit.

Retired employees are also allowed to remain in the State's health insurance program until they are eligible for Medicare. Employees retiring with at least 15 years of service are entitled to a retiree health insurance credit equal to $4 per month for each year of service. This credit is used to reimburse retirees for the cost of health insurance premiums. More information about the State's retirement benefits is provided in Chapter 5.

Paid Holidays, Annual Leave, Virginia Sickness and Disability Program Leave, and Life Insurance

The State offers various types of leave, including paid holidays, annual leave, traditional sick leave, and family and personal leave. As shown in Table 2, the annual leave available to employees increases with their years of service, and all employees receive 12 paid holidays, eight to ten days of sick leave, and four to five days of family and personal leave each year. Other types of leave are also available, including community service, civil and work-related, educational, emergency/disaster, family and medical leave, leave sharing, leave to donate bone marrow or organs, and military leave.

The State also has a managed disability program—the Virginia Sickness and Disability Program (VSDP)—that provides full or reduced compensation to employees if they are declared unable to work. This program includes short- and long-term disability benefits and long-term care insurance. The State contributes roughly 1.9 percent of an employee's salary each year to fund the long-term disability component of this program. Although these benefits were considered as part of employees' leave benefits and total compensation, a comprehensive review of the program itself was not within the scope of this study.

The State also provides other flexibilities that employees can use to balance the demands of work and other aspects of their lives, such as the ability to work part-time or telecommute. In 2008, 582 classified employees worked part-time for the State. More than 19,000 employees were eligible to telecommute; 2,443 took advantage of this flexibility. More information will be provided about the State's leave benefits and work/life flexibilities in Chapter 6.

Table 2: Types of Leave and Amount of Days Provided

	Annual Leave			VSDP[b]	
Years of Service	*Accrued*	*Carryover*	**Paid Holidays[a]**	*Sick Leave*	*Family and Personal Leave*
Less than 5 years	12	24	12	8	4
5	15	30	12	9	4
10	18	36	12	10	5
15	21	42	12	10	5
20	24	48	12	10	5
25 or more	27	54	12	10	5

[a] Depending on the year, the Governor at times grants additional paid holidays in July, November, and December.
[b] Employees in the traditional sick leave program represent approximately 20 percent of the classified workforce. These employees receive 15 days of sick leave per year.

Source: Department of Human Resource Management, 2008.

The State also provides basic and optional group life insurance to employees through VRS. Basic life insurance and accidental death and dismemberment insurance are offered to all employees and provide a death benefit of twice their salary. Employees have the option to purchase additional life insurance with a death benefit of up to four times their salary. The annual State contributions toward basic group life insurance are 0.82 percent of an employee's salary.

STATE WORKFORCE INCLUDES BROAD RANGE OF SKILLS AND IS LOCATED THROUGHOUT VIRGINIA

Few, if any, organizations have missions as comprehensive, complex, and critical as state governments. The classified State workforce implements programs that have missions ranging from managing and maintaining the State's transportation infrastructure, guarding public safety, providing human services to those in need, overseeing sales of alcoholic beverages, and registering citizens' motor vehicles. Consequently, the skills needed by the State workforce vary tremendously. To categorize the classified workforce around these skills, DHRM uses a job classification system consisting of occupational families, career groups, and job roles. Occupational families are the broadest tier in the system. There are seven occupational families, the largest of which is administrative services (Table 3).

Within each occupational family are various career groups—56 in total. Each career group includes at least one job role, and there are a total of 291 job roles. For example, within the public safety occupational family, there is a law enforcement career group. Within the Law Enforcement career group are job roles such as Law Enforcement Officer I and Law Enforcement Manager II. Administrative and

Table 3: Seven Occupational Families Comprise the Classified State Workforce

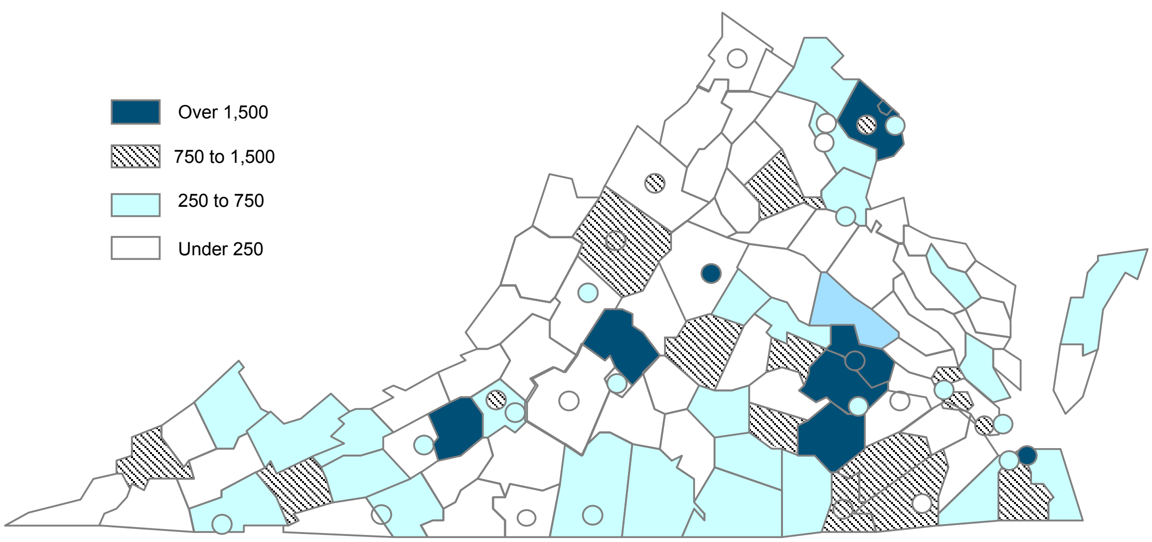
Occupational Family	# of Employees
Administrative services	22,077
Public safety	14,794
Trades & operations	11,875
Health & human services	9,706
Engineering & technology	6,609
Education & media services	4,571
Natural resources & applied science	3,997
Total	*73,629*

Source: Department of Human Resource Management, 2008.

Office Support is the largest career group with 12,167 employees. Security Services is second at 9,297, while Direct Services is third at 4,696.

The Department of Corrections (DOC) has the most classified employees at 12,298. The Department of Mental Health, Mental Retardation and Substance Abuse Services (DMHMRSAS) employs 8,854, while the Virginia Department of Transportation employs 8,491 classified staff. Because of the distributed nature of these large agencies and others, classified employees are located throughout the Commonwealth. As shown in Figure 1, the heaviest concentration is in the Richmond area. Universities and large DOC or DMHMRSAS facilities account for many of the instances in which large numbers of classified employees are in a given locality outside the Richmond area.

Figure 1: Location of Classified State Employees



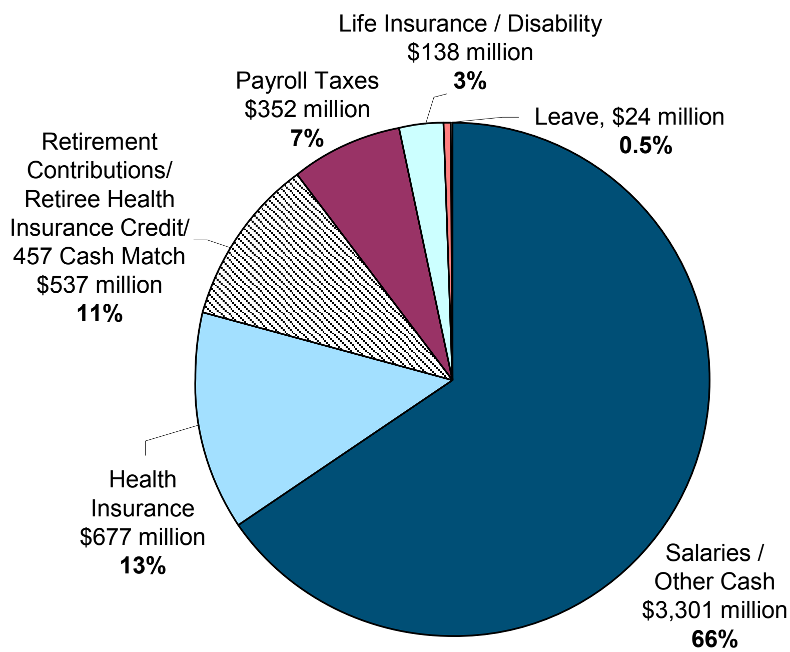
Source: Department of Human Resource Management, 2008.

COMPENSATION IS MAJOR PORTION OF STATE SPENDING AND KEY TO STATE OPERATIONS

Salaries and benefits are one of the State's primary means to recruit and retain the large and varied workforce described above. The State spent $5.028 billion in FY 2007 to fund salaries and benefits for State employees. Salaries account for about two thirds of Virginia's total compensation spending for State employees. Health insurance is the second largest category of spending at 13 percent, while pre-funding retirement and retiree health insurance credit contributions is the third largest at 11 percent (Figure 2).

In addition to being a major portion of State spending each year, compensation is also central to State government's ability to function properly. Not providing salaries and benefits that achieve their goals to recruit and retain a workforce can hinder agency operations and result in unnecessary expenditures.

Figure 2: Virginia Spent $5.028 Billion on State Employee Compensation in FY 2007



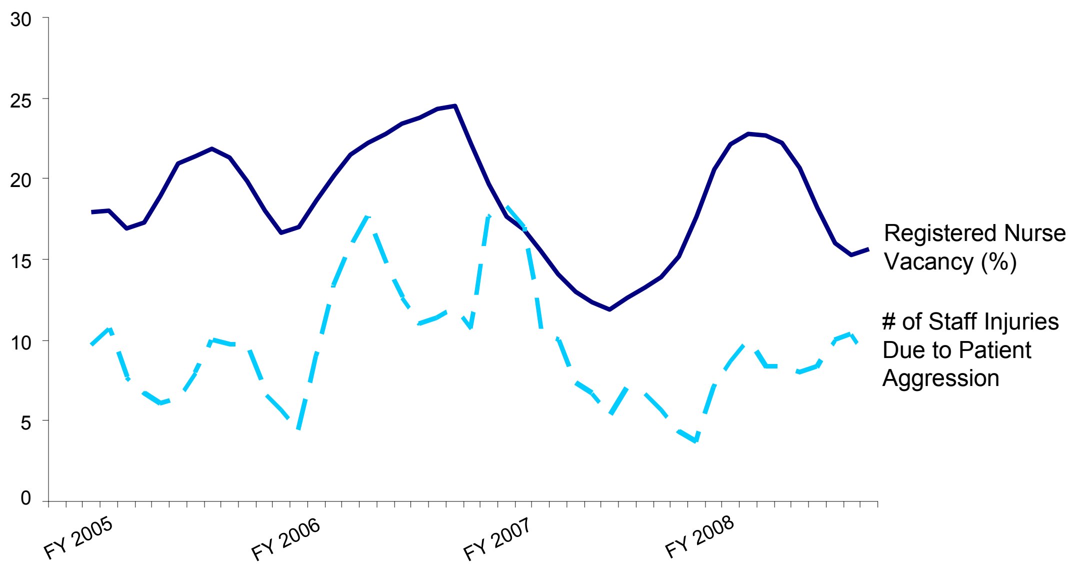
Notes: Salaries and other cash compensation is for classified State employees. Other spending is for all State employees enrolled in each respective benefit program. Health insurance spending represents State portion of health insurance premiums.

Source: *Data Point*, Virginia Auditor of Public Accounts, September 2008.

Above-Average Turnover Can Hinder Agency Operations

In 2007, the State's average turnover rate was 11.5 percent. Above-average employee turnover can have numerous negative impacts on an agency and its employees. When asked, agencies most frequently cited decreased efficiency or timeliness and lower quality service or products as the impact turnover has on their agency. Agencies noted that above-average turnover can also increase the workload of existing employees and contribute to increased employee absences or injuries. For example, the facility director and other key staff at the Northern Virginia Mental Health Institute pointed to a link between their vacancy rate for registered nurses and key operational indicators, such as the percentage of staff injured by aggressive patients. Monthly nursing vacancy and staff injury data since FY 2005 suggest there is a relationship (Figure 3), which underscores how recruiting and retention challenges can lead to operational difficulties for agencies.

Figure 3: Higher Nursing Vacancies Associated With More Staff Injuries



Note: Data calculated as a three-month, moving average to smooth monthly data volatility.

Source: JLARC staff analysis of Northern Virginia Mental Health Institute data, 2008.

Above-Average Turnover Results in Avoidable Costs

The Department of Juvenile Justice (DJJ) experienced 17 percent turnover in 2007, above the State average of 11.5 percent. DJJ has a particularly difficult time recruiting and retaining one of its most critical occupations, senior Juvenile Correctional Officers (JCO). The senior JCOs are charged with supervising residents in DJJ correctional facilities, which includes overseeing activities in housing units or recreation areas and transporting residents to medical or court appointments.

In FY 2007, DJJ reported that 118 senior JCOs left during the first year of their tenure. This represents more than one-quarter of the total number of senior JCOs employed by DJJ. In addition to the operational challenges presented by this turnover, it also resulted in avoidable costs, such as

- $1.06 million to provide the mandatory 12-week training for the 118 new JCOs that subsequently left; and
- $1.6 million in additional overtime paid to JCOs that was attributable to "covering" the vacant JCO positions.

In addition to this $2.6 million in avoidable costs, this turnover also results in less measurable but still critical costs such as lost productivity and lower employee morale.

JLARC STAFF REVIEW OF TOTAL COMPENSATION

The remainder of this report is based on the major research activities conducted by JLARC staff, PwC, and Mercer. The research activities conducted by JLARC staff included analyses of existing datasets about employee salaries and benefits, more than 100 interviews to obtain the employer and employee perspectives, and three major surveys of State agencies and their employees. PwC and Mercer independently provided information about best practices and trends, benchmark data of how current State salaries and benefits compare to what other major employers provide, and an assessment of the State's current approach and recommended alternatives or changes. Each of these research activities is addressed throughout this report and described more fully in Appendix C.

This report's findings, recommendations, and options regarding the State's current approach to employee salaries and benefits stem from the collective work conducted by JLARC staff and the consultants. JLARC staff, PwC, and Mercer generally agreed on the extent to which the State's purposes for total compensation are being achieved, how current salaries and benefits compare to other major employers, and whether or not changes should be made. This convergence of research findings and expert opinion confirms the need for the General Assembly to carefully consider any potential modifications to the State's compensation of employees to ensure that the purposes of compensation are achieved.

Chapter 2

Total Compensation

In Summary

In 2007, the average turnover rate among classified State employees was 11.5 percent, which compares favorably to the turnover rates of other governments and the private sector. When compared to other large employers in Virginia, the current total compensation package offered to State employees is generally competitive, but is below a competitive range for some job roles and above a competitive range for others. The low statewide turnover rate and generally competitive total compensation package together suggest that, overall, current total compensation is adequate to recruit and retain employees. However, within this overall perspective, challenges exist. Chief among these are the higher staff turnover in many correctional and mental health facilities and the concern by some that total compensation is not sufficient to recruit and retain an adequate workforce. More broadly, the current process to manage salaries and benefits could be more coordinated and better address compensation goals and purposes. Consequently, the State needs to develop a total compensation strategy to guide decision-making about salaries and benefits.

The mandate for this study directed JLARC staff to review the adequacy of salaries and benefits for State employees. This chapter assesses the adequacy of the total compensation the State provides for the purposes of recruiting and retaining employees. The study mandate also directed JLARC staff to compare salaries and benefits for State employees to those provided by other public and private employers. This chapter includes summary information about how competitive total compensation is, as well as its role in employee decisions to work for, and continue to work for, the State. Detailed assessments of the role that each major component of compensation plays in recruitment and retention, and in achieving the other compensation objectives, are provided in Chapters 3 through 6.

MOST AGENCIES ARE ABLE TO RECRUIT AND RETAIN A WORKFORCE, BUT CERTAIN AGENCIES AND JOB ROLES REPORT WORKFORCE CHALLENGES

The most critical purposes of salaries and benefits are for the State to recruit and retain a workforce to administer programs. The perspectives of the agencies as employers in addition to data regarding employee turnover provide the most direct insight into whether the current salaries and benefits are effective at recruiting and retaining staff.

Most Agencies Report Total Compensation Attracts Qualified Staff and Have Relatively Low Employee Turnover

JLARC Staff Survey of State Agencies

In August and September 2007, JLARC staff surveyed the 145 agencies and facilities which DHRM's records indicate employed classified staff. The survey was to be completed by the agency human resources director, and was to be reflective of the agency's overall perspective as an employer. JLARC staff received responses from 132 agencies, or 91 percent of those notified. More information about this survey is in Appendix C.

According to the JLARC staff survey of State agencies, 81 percent of the agencies that employ classified staff agreed that the total compensation they offer allows them to attract staff who are sufficiently qualified, but not necessarily the top talent. In 2007, the turnover rate for the classified State workforce was 11.48 percent, down from 13 percent in 2006. This is comparable to other surrounding states and the national state average of 11.2 percent in 2007. Virginia's turnover in 2007 was slightly lower than the federal government and much lower than the private sector (Table 4).

The fact that most agencies believe that total compensation allows them to attract staff, along with the favorable statewide employee turnover figure, suggest that, broadly speaking, the goals of recruiting and retaining sufficient staff are being achieved.

Table 4: Virginia's Turnover Rate Compares Favorably to Other Governments and the Private Sector

Employer	Average Turnover Rate
Virginia	11.48%
Maryland	12.95
North Carolina	12.73
South Carolina	16.30
Tennessee	11.14
West Virginia	13.27
Federal government	12.50
Private sector (Southern region)	42.90

Source: Virginia Department of Human Resource Management, National Association of State Personnel Executives, U.S. Office of Personnel Management, and U.S. Bureau of Labor Statistics.

DOC, DMHMRSAS, and Some Universities Report Total Compensation Does Not Attract or Retain Qualified Staff

Certain agencies, however, are struggling to recruit and retain key portions of their workforce. For example, the Department of Corrections (DOC) and Department of Mental Health, Mental Retardation and Substance Abuse Services (DMHMRSAS) facilities were less likely to agree that the total compensation they offer allows them to attract staff who are sufficiently qualified, but not necessarily the top talent. Furthermore, all nine of the agencies that strongly disagreed that the total compensation they offer allows them to maintain a sufficient workforce were either DOC or DMHMRSAS facilities.

In 2007, 18 agencies with 50 or more employees had turnover above 20 percent. All but two of these agencies were either DOC or DMHMRSAS facilities (Virginia School for the Deaf and Blind and Department of Veterans Services were the other agencies). These prisons, mental health facilities, and training centers tend to be located in more competitive economic regions of the State. All but three of the 16 DOC or DMHMRSAS facilities with turnover higher than 20 percent were in either Northern Virginia, Tidewater, or the Richmond area. An additional 16 agencies had turnover between 15 and 20 percent. Twelve of these were either DOC or DMHMRSAS facilities, with the others being the Department of Juvenile Justice and Radford, George Mason, and Virginia Commonwealth universities.

Finally, key DOC and DMHMRSAS staff are among the State job roles with the highest turnover. Direct Service Associates, Licensed Practical Nurses, and Security Officers are three of the seven job roles with turnover in 2007 of 20 percent or more (Table 5). These three job roles alone represent more than 11,000 employees and are therefore a major driver of the State's overall turnover rate. In addition, universities employ many of the Lab & Research Specialists and Trades Technicians, while Housekeeping & Apparel Workers and Food Service Technicians are primarily employed by DOC, DMHMRSAS, and the universities.

Table 5: State Job Roles With Turnover of 18 Percent or More

Job Role	Average # of Employees	Turnover Rate
Emergency Coordinator I	106	25%
Direct Service Associate II	3,598	24
Lab & Research Specialist I	325	24
Licensed Practical Nurse	650	23
Law Enforcement Officer I	224	20
Security Officer III	7,207	20
Trades Technician II	81	20
Registered Nurse I	659	19
Housekeeping & Apparel Worker I	470	19
Food Service Technician II	162	18

Note: Includes job roles with 50 or more employees.

Source: Virginia Department of Human Resource Management, 2008.

Salaries and Benefits Are Important, but One of Multiple Factors That Can Influence Recruitment and Retention

While the salaries and benefits the State offers are provided to help recruit and retain staff, a range of factors determine whether an agency is able to build and maintain a workforce. As shown in

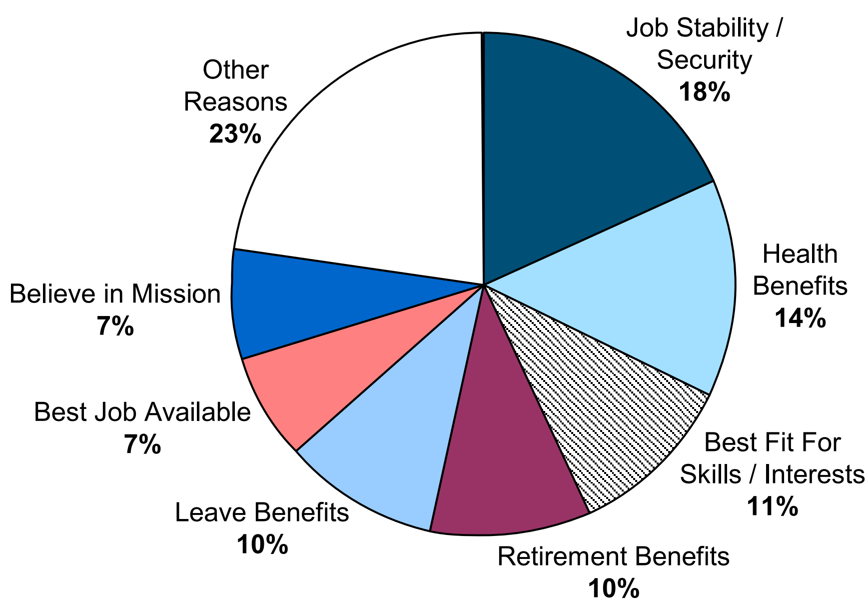
Figure 4, the State's most powerful recruitment and retention tool is the generally stable nature of working for the Commonwealth.

JLARC Staff Survey of Classified State Employees

Between January and April 2008, JLARC staff invited 58,068 classified State employees to complete an online survey about their salaries and benefits. Invitations were sent to all classified employees with an e-mail address on file with DHRM as of early 2008. JLARC staff received 21,696 responses, which was about 38 percent of those notified. More information about this survey is in Appendix C.

According to the JLARC staff survey of classified State employees, the stability and security of State service was the most frequently cited reason why employees initially chose to work for the State. Job stability and security was also the most cited reason why employees continue to work for the State. The health-care benefits were the second most frequently cited reason why employees chose to work for the State and why they continue working for the State.

Figure 4: Employees Initially Choose to Work for the State for a Variety of Reasons



Note: Includes responses from 21,682 employees. Respondents could select up to three reasons, resulting in a total of 54,338 responses. Percentages shown represent the proportion of the total reasons cited by respondents.

Source: JLARC staff survey of classified State employees, 2008.

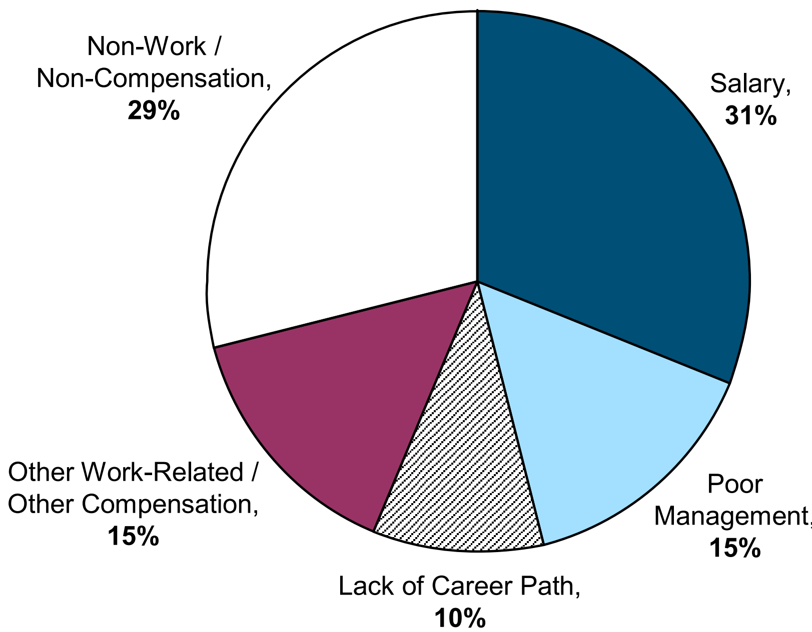
As part of their standard exit processing, agencies typically ask employees who resign their reason for leaving. This information is then provided to DHRM. In recent years, the most frequently cited reason why employees resign has been "other." Consequently, JLARC staff created an additional survey to ask employees why they leave their job, and importantly the role, if any, compensation played. The survey was designed to determine whether people left because of (1) compensation, (2) other work-related reasons, or (3) reasons other than compensation or work.

According to the JLARC staff survey of employees who left State employment, salary was the most frequently cited reason why employees left their job during FY 2008 (Figure 5). Poor management and a lack of career path were cited as reasons for leaving by 15 and ten percent of employees, respectively. An additional 15 percent cited other work-related or other compensation issues, such as not feeling appreciated or schedule difficulties. Broadly speaking, about one-third of turnover was due to compensation and another one-third was due to other work-related reasons.

JLARC Staff Survey of Employees Who Left State Employment

During FY 2008, JLARC staff asked agency human resources staff to provide employees who voluntarily left their job with a flyer. The flyer directed the employee to a confidential JLARC online survey asking the primary and other reasons behind their decision to leave. JLARC staff received 701 responses, approximately 13 percent of the employees that voluntarily left during the period. More information about this survey is in Appendix C.

Figure 5: Employees Left Their State Job for a Variety of Reasons



Note: Includes 701 responses.

Source: JLARC staff survey of employees who left State employment, 2008.

Importantly, most employees did not base their decision to leave on a single reason. Rather, multiple factors often influence their decision. For example, survey results showed that although salary is not the largest primary reason for leaving among higher education employees, it is the most influential factor, impacting 48 percent of decisions.

Collectively, these survey findings underscore that total compensation alone is not the only determinant of the State's ability to recruit and retain its employees. Yet, it is certainly a key factor.

MERCER FOUND VIRGINIA'S TOTAL COMPENSATION IS GENERALLY COMPETITIVE WITH OTHER LARGE EMPLOYERS

Because compensation plays an important role in recruitment and retention, JLARC staff directed Mercer to compare the salaries and benefits offered for selected State job roles to other large organizations. Due to the scope and breadth of the State's operations, it competes for employees with large and small employers in nearly every sector of the economy. Employees responding to the JLARC staff survey of classified State employees reported they considered employment by the federal government, other state governments, local governments, and the private and non-profit sectors. The most frequently cited competitor was the private sector, followed by the federal and local governments.

Total Compensation Comparison

Mercer and JLARC staff worked with DHRM staff to identify 43 job roles for comparison to other employers. Mercer benchmarked selected Standard Occupation Codes in each of the job roles, covering 37,320 classified State employees.

Mercer calculated an "index score" that compared Virginia's total cash compensation to Virginia-specific or regional market data from its own databases, as well as Watson Wyatt Data Services, Southeastern States Salary Conference, Business and Legal Reports, Gartner, Inc., and D. Dietrich Associates, Inc.

Mercer then calculated a total benefit index that compared Virginia's benefits to 16 other large employers in Virginia using Mercer's methodology to assign a dollar value to the benefits. These two index scores were combined to create a composite total compensation index score.

More information about Mercer's analysis is provided in Appendix C.

Section 2.2-1202 of the *Code of Virginia* states that:

> It is a goal of the Commonwealth that its employees be compensated at a rate comparable to the rate of compensation for employees in the private sector of the Commonwealth in similar occupations. In determining comparability, consideration shall be given to the economic value of fringe benefits in addition to direct compensation.

Mercer Found That Virginia's Total Compensation Is Competitive With Other Large Employers, but Varies Widely by Job Role

To provide more perspective on whether the salaries and benefits that Virginia provides are comparable to other employers, Mercer compared the total compensation that Virginia offers to that of other large employers in the State. JLARC staff and Mercer collaborated with DHRM to identify 43 representative job roles across all seven occupational families. Selection of these 43 job roles prioritized: coverage across the seven occupational families, practitioner and managerial job roles, job roles that included substantial numbers of State employees, and job roles in which the State was experiencing recruitment and retention challenges.

Mercer then used various databases and market surveys reflecting cash compensation paid by hundreds of organizations to create a total cash compensation index score. In addition, JLARC staff and Mercer chose 16 large peer employers in Virginia to use as the comparison group from which to create a total benefits index score (Exhibit 1). The 16 employers are among the State's largest and include public, non-profit, and private employers. The private sector employers were selected in part based on whether they employed large numbers of people in one of the State's seven occupation families and would therefore compete with the State for workers in those fields.

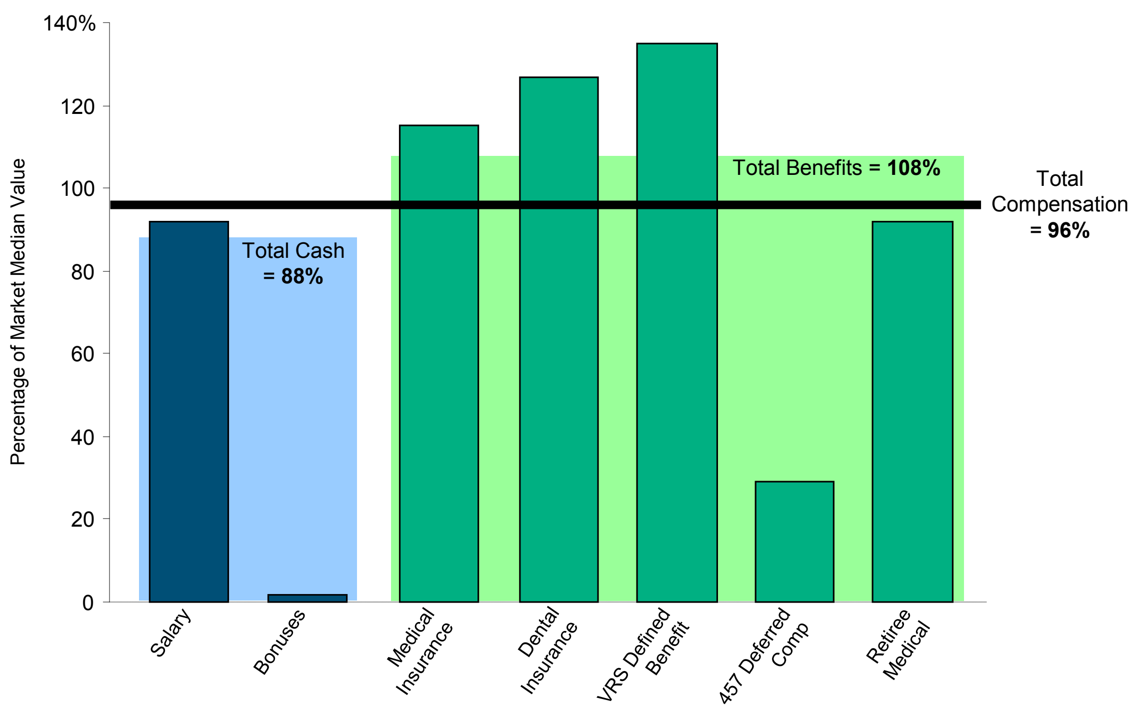
Exhibit 1: Large Peer Employers for Total Benefits Index Score

Public and Non-Profit	Private, For-Profit
Fairfax County, Virginia	Capital One Financial Corporation
Henrico County, Virginia	Dominion Virginia Power
Rockingham Memorial Hospital	Interstate Hotels and Resorts
The Nature Conservancy	The Kroger Company
U.S. Department of Defense	Media General, Inc.
U.S. Department of Homeland Security	Philip Morris USA
U.S. Office of Personnel Management	Science Applications International Corp.
	Sunrise Senior Living
	United Parcel Service

Source: JLARC staff analysis of Mercer data, 2008.

Mercer then combined the total cash compensation and total benefits index scores to create a composite total compensation index score. As shown in Figure 6, the composite total cash and total benefits index scores resulted in a total compensation index score of 96 percent of the market median. This suggests that when considering the total value of all cash compensation and benefits, Virginia's compensation is below the median value by about four percentage points. The individual components of the total cash (for example, salary) and total benefits (for example, VRS defined

Figure 6: Mercer Benchmarked State's Salaries and Benefits at 96 Percent of Market



Note: Total benefits benchmark score also includes group life insurance and dependent and health flexible savings accounts, which received scores of 169, 83, and 79 percent of the median, respectively.

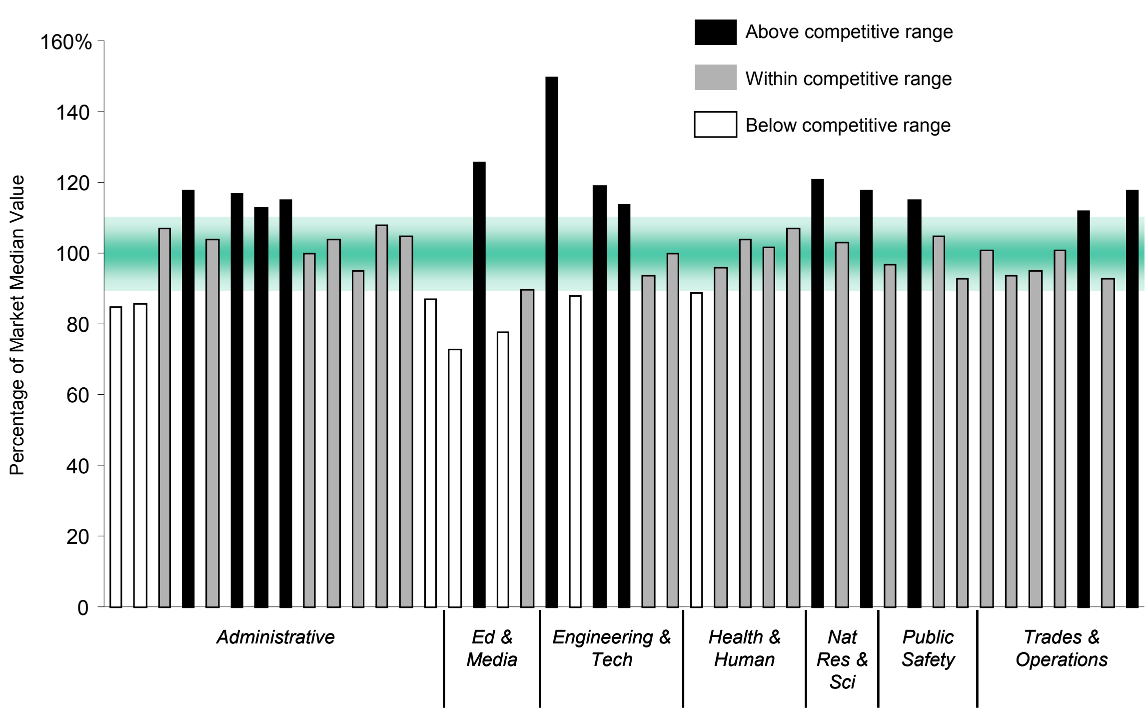
Source: JLARC staff analysis of Mercer findings, 2008.

benefit retirement plan) scores will be discussed in more detail in Chapters 3 through 6 of this report.

Within the overall total compensation index score of 96, the different salaries provided to employees in each of the 43 representative job roles resulted in total compensation that was within, above, and below a competitive range. Absent any statutory or policy guidance about how Virginia defines compensation "comparable" to other employers, JLARC staff considered total compensation between 90 and 110 percent of the market median as competitive. According to Mercer, Virginia's total compensation was between 90 and 110 percent of the market median for 23 of the 43 job roles. Total compensation was more than 110 percent for 13 job roles and below 90 percent, less than competitive, for the remaining seven job roles.

Figure 7 illustrates the variability across job roles, which in the figure are organized by the seven occupational families. Across the seven occupational families, there are instances in which total compensation is either within the competitive range, above, or below competitive. Across all seven occupational families, total compensation ranged from 73 to 150 percent of the market median.

Figure 7: Total Compensation Is Competitive for Most Benchmarked Job Roles, yet Varies Widely



Source: JLARC staff analysis of Mercer data, 2008.

Total Compensation Assessment Underscores Complex Role Salaries and Benefits Play in Recruitment and Retention. Virginia tends to be less competitive compared to other employers for its above average turnover job roles than it is for job roles with average or below average turnover. As shown in Table 6, all 14 of the benchmarked job roles with above average turnover received a total compensation index score of less than 110 percent of the market median. In contrast, only four of the 29 job roles with average or below average turnover received total compensation less than 90 percent of the market.

Despite a tendency for the State's total compensation to be less competitive for above average turnover job roles, there are instances in which this tendency does not hold true. For example, the Administrative Office Specialist II job role had 10 percent turnover in 2007, which was below the State average of 11.48 percent. Virginia's total compensation for this job role received an index score of 85. Yet, despite this relatively lower score compared to other employers, the vast majority of the more than 2,500 employees in this job role chose to remain with the State in 2007. This example further underscores the variety of factors, especially those unrelated to compensation, such as job stability, that can also play a large role in the State's ability to recruit and retain employees.

Table 6: Job Roles With Less Competitive Total Compensation Tend to Have Above Average Turnover

	Total Roles Benchmarked	Comparison to Market Median Total Compensation					
		< 90%		*90% to 110%*		*> 110%*	
		#	%	#	%	#	%
Above average turnover	14	3	21%	11	79%	0	0
Average / below average turnover	29	4	14	12	41	13	45

Source: JLARC staff analysis of Mercer data, 2008.

Broad Total Compensation Assessments Provide Strategic Insight, but Are Not Useful for Individual Total Compensation Adjustments. Various organizations, including DHRM and the Virginia Governmental Employees Association, cite various sources to arrive at an average gap between public and private employee compensation. These figures focus primarily on salary rather than total compensation. The results of the Mercer analysis above highlight the concern in any such calculation, which is that the average index score masks potentially wide variation. For example, the Architect / Engineer II job role received a score of 150 and the Education Support Specialist II job role received a score of 73. Using the average index score of 96 to attempt to adjust the total compensation of all employees would (1) only increase the total compensation provided to the Education Support Specialist II to an index score of 77, and (2) increase the Architect / Engineer II to an index score of 154. Such an approach would likely not sufficiently close the gap in the former case and would exacerbate the difference in the latter case.

Broad total compensation assessments can mask or dilute issues that may legitimately exist within a single agency or for smaller groups of employees.

Furthermore, broad total compensation assessments can mask or dilute issues that may legitimately exist within a single agency or for smaller groups of employees. For example, total compensation for the Direct Service Associate II job role received an index score of 96. However, within this statewide figure there are employees in this job role employed at facilities in Fairfax County and Roanoke County, environments with different local economies and competitor employers.

Simply stated, while broad total compensation assessments or salary surveys can provide useful strategic insight about the general tendency of total compensation, they can be misleading in isolation and should be combined with a variety of other analyses to provide appropriate context and guidance about what total compensation should be. DHRM's state workforce planning report emphasizes this point as well, noting that "market data needs to be used in conjunction with other staffing measures to identify jobs for which compensation changes are most needed."

More detailed comparisons of State employee salaries and benefits to other large organizations is provided in Chapters 3 through 6.

Total Value of Salaries and Benefits Not Readily Apparent to All Employees

As noted above, in most cases the State provides a total compensation package that is competitive with what other large employers offer. However, interviews conducted by JLARC staff with classified State employees suggest that certain factors that make the package competitive, such as the five percent member contribution that is paid by the State into the retirement system or the State's share of health insurance premiums, are not readily apparent to employees. This is likely more true in recent years, given that employees have their paycheck electronically deposited to a bank account and do not receive paper pay-stubs along with their check twice a month.

Employees can still, however, view an electronic pay-stub through Payline (which is a website available to all employees that provides information about their total compensation). Employees can also use Payline to view the value of what the State contributes on their behalf for a given pay period, and cumulatively throughout the year. Although this information is available, it is unclear how many employees access it and consequently ascertain the full value of the compensation the State provides. Moreover, this information is likely not used as much as it could be to help recruit prospective employees who do not have access to Payline. A few agencies have created web-based calculators to help prospective employees better understand the total value of compensation they would receive as a State employee, including what is paid by the State on their behalf. However, given that this information already exists in electronic format through Payline, there are likely opportunities to better use this information to make current—and prospective—employees more aware of the total value of the compensation the State offers.

An annual total compensation statement provided to each employee would ensure that employees are aware of their compensation. According to a national MetLife study of employee benefit trends, 65 percent of companies with 500 or more employees provide a total compensation statement. Exhibit 2 is an illustrative example of a statement that could be created to show the value of the total compensation the State provides to its employees.

Recommendation (1). The General Assembly may wish to require the Department of Human Resource Management (DHRM), with assistance from the Virginia Retirement System, to prepare an annual statement of total compensation for each classified employee. The General Assembly may also wish to require independent, legislative, and judicial agencies, and institutions of higher education to prepare the annual statements for their employees based on instructions from DHRM. The statement should account for the full cost to the State and the employee of cash compensation as well as Social Security, Medicare, retirement, deferred compensation, health insurance, life insurance, and other benefits.

VARIED AND AGING WORKFORCE PRESENTS STRATEGIC CHALLENGES

Any large employer, including the State, is presented with the challenge of offering total compensation that is sufficient to build a highly varied workforce. In addition to the variation in occupations and skills noted in Chapter 1, State employees also range in age from under 20 to more than 80 years old.

Employees of Different Ages Place Varying Importance on Salaries and Benefits

The JLARC staff survey of classified State employees asked respondents to answer 13 questions identifying elements of total

Exhibit 2: Illustrative Example of a Total Compensation Statement

Annual Total Compensation Statement

Compensation Period: Jan 1 08 – Dec 31 08

Employee: John Doe Agency: Department of Corrections

Deferred Compensation Rate: $40/pay	Health Insurance Plan: COVA Care (family, with basic dental)
Annual Leave Accrual: 15 days	Value of Leave Accrual: $ 2,431.20
State Holidays: 12 days	Value of State Holidays: $ 1,944.66
Sick and Personal Leave: 13 days	Value of Sick and Personal Leave: $ 2,106.60

Your total compensation for 2008 was $66,239.01

Compensation Item	What the State Paid for You	What You Paid	Total Value of Your Compensation
Gross Salary	$ 42,132.00		
(Less Your Deductions for Benefits)	(6,244.51)		
Net Salary	35,887.49		35,887.49
Cash Bonus	1,000.00		1,000.00
Social Security	2,674.18	2,674.18	5,348.36
Medicare	625.41	625.41	1,250.82
VRS Employer Contribution	2,624.82		2,624.82
VRS Employee Contribution*	2,106.60	0.00*	2,106.60
Deferred Compensation		960.00	960.00
Deferred Compensation Match	480.00		480.00
Retiree Health Insurance Credit	497.16		497.16
Health Insurance	12,936.00	1,836.00	14,772.00
Group Life Insurance	345.48		345.48
Long-Term Disability Insurance	817.36		817.36
Medical Reimbursement Account			
Dependent Care Reimbursement Account			
Optional Group Life Insurance		148.92	148.92
Optional Long-term Care Insurance			
Total	**$59,994.50**	**$6,244.51**	**$66,239.01**

*State pays your share of VRS retirement.

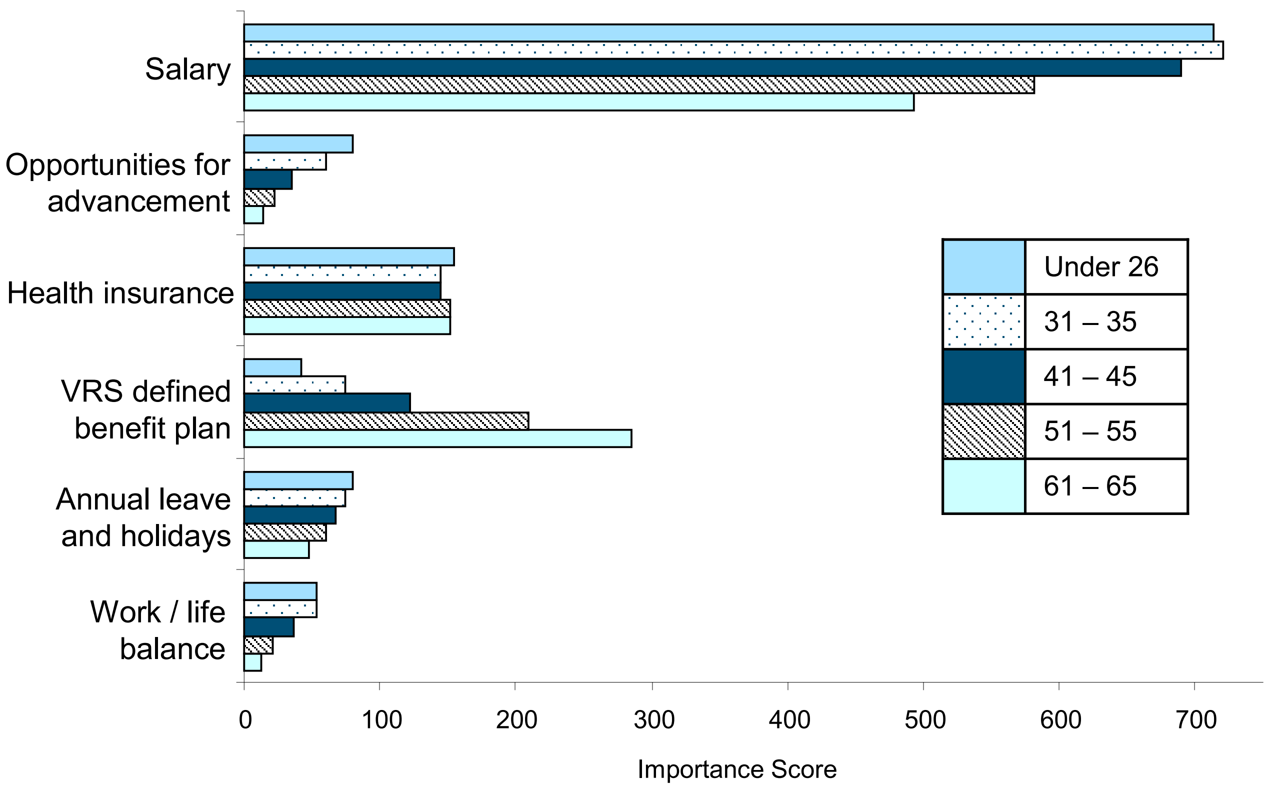
Source: JLARC staff analysis of employee total compensation.

compensation as either the most important or least important. Mercer then calculated the relative importance of the 13 elements of compensation for each employee, using a scale of 1300 that assigned each element a neutral value of 100. The more times an employee selected a compensation element as most important, the greater its relative importance score. The results provide insight into the relative importance that employees place on the various elements of their compensation package. Such insight can be instructive in constrained environments about where employees would most value current or additional resources being provided.

For all 21,696 classified employees that responded, salary was four times as important as health insurance, which was the second most important element of compensation. As shown in Figure 8, employees place varying degrees of importance on certain elements depending on their age. For example,

- The importance of the VRS defined benefit retirement plan increases steadily as employees age, with employees age 61 to 65 rating the retirement plan nearly seven times as important as those under 26.
- Employees under age 26 rate opportunities for advancement nearly six times and work / life balance four times as important as employees between ages 61 and 65.

Figure 8: Employee Compensation Preferences Vary by Age Group



Note: Selected age ranges are shown for illustrative purposes, but importance scores for age ranges shown are representative of scores for age ranges not shown in that they are consistent with the general progression of importance scores from younger age groups to older age groups.

Source: Mercer analysis of results of JLARC staff survey of classified State employees, 2008.

These differences in the importance that younger and older employees place on certain elements of their salaries and benefits make it challenging for the State to provide a single compensation package that appeals to all employee age groups equally. This is especially true given that while the average classified employee is 46 years old, more than 16,000 employees—about 20 percent of the workforce—are either under 30 or over 60.

More broadly, the State is attempting to recruit and retain workers from several generations at once. This is especially true considering the enduring nature of most State programs. At any given time, an agency may employ a 19-year-old recent high school graduate and a 59-year-old with more than 30 years of service. Since the 1970s when the 59-year-old employee was hired, the workforce has become more mobile, older, and wants more choice and flexibility than previous workforces. For example,

- *Increased career mobility* – The concept of a single employer during a person's career is increasingly a fleeting notion. Newer generations of workers fully expect to work for multiple employers during the course of their career. Even the baby boomer generation is holding on average 10.5 jobs during their lifetime, according to the Bureau of Labor Statistics.

- *Increased percentage of older workers* – Workers, at times not by choice, are also now working into later years than previously. According to the U.S. Census, 23.2 percent of people between 65 and 74 were employed in 2007, up from 19.6 percent in 2000. The State workforce is experiencing similar trends, with the percentage of the workforce over 60 nearly doubling from 6.6 percent to 11.2 percent between 1991 and 2007.

- *Increased desire for choice and flexibility* – According to Deloitte Consulting, workers today want direct and personal control over when, where, and how they work. This has implications for the extent to which the total compensation package and broader work environment can be customized to meet each workers' needs—but within the overall objectives of the employer.

Aging Workforce Increases Need for Strategic Planning

The aging of the State workforce—and broader trend for people to work later in life—presents unique workforce planning challenges for the State. As of early 2008, about 10 percent of State employees were eligible to retire, and this is projected to more than double over the next five years.

DHRM and agencies report that transition planning and knowledge transfer are among the strategies to prepare for these retirements. However, these strategies have little use if those retiring have no one to transfer their knowledge to. Such a situation may exist within career groups for which agencies struggle to retain younger workers in the lower level practitioner job roles, and have especially high eligibility to retire among those in the higher level managerial job roles.

Aging Workforce Also Presents Opportunities

AARP / Towers Perrin research found that older workers are more motivated to exceed expectations than younger workers. The Partnership for Public Service cites a survey of human resources professionals indicating that 68 percent considered older workers to be more reliable employees.

Several career groups appear at particular risk of not being able to develop this sufficient "bench strength" that will be needed to adequately transition when those in the managerial roles eventually retire. The security services career group is an example. In 2007, there was 20 percent turnover among the more than 7,000 employees in the Security Officer III job role. As of early 2008, more than 50 percent of employees in the Security Manager III, IV, and V job roles were eligible to retire. The percentage of those in managerial job roles eligible to retire is projected to further increase in 2013 and 2018. The law enforcement, nursing and physician assistant, and education administration career groups are projected to experience similar trends.

The aging State workforce will also exacerbate the level of financial risk associated with health insurance and retirement benefits. Health costs increase as people age, and as a larger percentage of the State workforce is older, total health costs will likely be higher. Additionally, as more employees retire, the VRS trust funds will be required to disperse more in benefits.

IMPROVEMENT NEEDED IN STRATEGIC MANAGEMENT OF SALARIES AND BENEFITS

The strategic challenges noted above, along with the issues presented throughout the remainder of this report, place a premium on having a sound approach for making strategic compensation decisions. Such an approach needs to be coordinated across the branches of government and elements of compensation, and also driven by clear purposes and goals. While a foundation exists for such an approach, process and organizational changes are necessary.

Process to Manage Salaries and Benefits Could Better Address Compensation Goals and Purposes; Coordination Required

Currently, DHRM and the Department of Planning and Budget (DPB) coordinate each year to assess agency requests for additional funding, primarily for employee salaries. The Governor's budget then includes requests for the General Assembly's consideration. Recent dialogue between the executive and legislative branches about salaries has primarily centered around (1) whether an annual performance increase should be given to all employees rated "contributor" or above and (2) how much the increase should be.

Decisions about how to manage health insurance are made primarily within the executive branch. In recent years, these decisions have resulted in important cost control measures; however, this approach has also led the State to absorb the bulk of cost increases, as is discussed in Chapter 4. Finally, changes to the retirement system are typically attempted through legislation, with dozens of bills to enhance employee retirement benefits introduced during recent sessions of the General Assembly. These requests in recent years to enhance benefits have been made despite the decline in the funded status of the retirement plans and during a time when there have been lower annual contributions than what is certified by the VRS Board.

Purposes of Compensation Not Primary Consideration in Many Salary or Benefit Decisions. Throughout the decision-making process briefly described above, the purposes of compensation are in many cases not among the primary criteria considered. This is evidenced by the fact that both the decision package template agencies submit to request funds for salary increases and the fiscal impact statement template that is completed for changes to the retirement system lack any explicit discussion of the purposes of providing salaries or retirement benefits. Neither template prevents addressing the purposes of salaries and benefits, but the templates do not address the extent to which the proposed change would improve recruiting, retention, motivation, or employees' ability to retire at the appropriate time with adequate benefits. A JLARC staff review of recent decision packages and fiscal impact statements found that absent an explicit requirement, the completed documentation in nearly all cases does not directly address these most critical of considerations.

Lack of Clear Goals Makes Justifying Decisions to Change Salary and Benefits Difficult. About two-thirds of the State's compensation spending is on salaries and one-third on benefits and taxes. Based on Mercer's assessment of the State's salaries and benefits, total compensation was 96 percent of market median. Total cash compensation was benchmarked at 88 percent of the market, while total benefits were benchmarked at 108 percent of the market median. Guidance about whether this standing compared to other employers is appropriate, as well as for other critical issues related to total compensation, is largely absent from both statute and policy. For example, the State has no agreed-upon goal for how many of its employees should participate in its health insurance program, which jobs are most critical to have staffed with top talent, or what percentage of pre-retirement income retires should receive.

For the purposes of this review, JLARC staff made assumptions that were necessary to evaluate the current approach. These include assigning a range of 90 to 110 percent of the market as competitive for total compensation. However, without clear and agreed-upon goals or targets for compensating employees, agencies, DHRM, DPB, the Governor, and the General Assembly have no consistent basis upon which to decide whether or not changes are necessary.

Coordination Across Multiple Organizations and Systems Necessary to Review Total Compensation. During the course of this review, JLARC staff worked closely with DHRM, VRS, and agency human resources staff to build an extensive dataset about the State's compensation approach. This dataset was created by extracting volumes of information from numerous State data systems, and augmented by three major JLARC staff surveys and more than 100 interviews. In addition, JLARC contracted with Mercer and PwC to conduct various analyses, which in summary form resulted in more than 1,500 pages of information. Simply stated, the voluminous information necessary to assess the salaries and benefits the State provides does not reside in a single place—and is time consuming and complicated to collect and aggregate.

Current Strategic Planning Efforts Are Foundation for Organizational and Process Improvements

Strategic Workforce Planning

Workforce planning, in the context of broader strategic planning, is a critical and necessary component of making decisions about whether changes are needed to salaries and benefits. In March 2008, *Governing* magazine gave Virginia a grade of "A" for human resources management, highlighting strategic workforce planning as a strength.

Despite the lack of clearly defined goals or a fully-coordinated approach to compensation, the State has still managed to develop a salary and benefit package that is in most cases adequate and competitive. Given the strategic challenges that lie ahead, however, the State needs to improve its approach to managing the $5 billion spent on State employee salaries and benefits. A partial foundation for the needed improvements is already in place. In 2004, agencies were required to submit individual workforce plans to DHRM, which culminated in the first statewide workforce plan in 2005. DHRM issued an updated plan in 2007. Both workforce plans identified many of the issues noted throughout this report, including the State's recruitment and retention challenges, differences between market and State employee salaries and annual increases, and potential impact of the aging workforce.

However, these important issues raised by DHRM and agencies do not appear to receive sufficient attention. This is likely in part due to the fact that they are perceived as isolated human resource issues. But as demonstrated throughout this report, salaries and benefits are a large portion of State spending and central to agencies' abilities to execute their missions. Because of the prominent role that salaries and benefits play from a budgetary and programmatic perspective, strategic decisions about salaries and benefits need to be addressed more formally.

Commonwealth Needs a Total Compensation Strategy

In addition to the workforce plan noted above, DHRM also has a strategic plan that includes objectives to improve customer service to agency staff and employee health. However, more broadly speaking, the process by which the level of salaries and benefits is considered should be based on an established set of principles and goals. These principles and goals—for example, how the State wishes to define "comparable" to the private sector as described in Section 2.2-1202 of the *Code of Virginia*—should be articulated in a statewide total compensation strategy.

Mercer identified total compensation strategies as a best practice …

Mercer identified total compensation strategies as a best practice, and raised concern that absent a total compensation strategy driven by principles and goals, the State has no foundation from which to make decisions about the level of salaries and benefits it provides. Consequently, Mercer suggested that the State develop a total compensation strategy.

At a minimum, the strategy should identify key principles and goals by answering some fundamental questions that are highlighted and discussed in more detail throughout this report (Exhibit 3). Articulating these principles and goals in a strategic document will provide the foundation from which to decide, for example, what proportion of cash compensation and benefits the State wants to provide as part of its total compensation package. The total compensation strategy will need to be continually refined as conditions change, particularly in the broader environment for health insurance. For instance, the impact that salary and benefit changes will have on the State's competitive position will depend, in part, on whether other employers also make changes to their total compensation packages.

Recommendation (2). The Governor and the General Assembly may wish to direct the development of a total compensation strategy that builds from the current workforce planning approach and is further integrated into the State's strategic planning and budget process. The total compensation strategy should identify principles and goals to assist in managing salaries and benefits. The total compensation strategy should also identify the specific actions the State will undertake to be consistent with and achieve the principles and goals.

Exhibit 3: Questions to Help Identify Key Principles and Goals for Total Compensation

Total Compensation	• What is an acceptable range of statewide employee turnover?
	  ○ For what jobs is the State willing to experience above-average turnover?
	  ○ For what jobs does the State want below-average turnover?
	  ○ What jobs are most critical to have sufficiently staffed?
	  ○ What jobs are most critical to have staffed with top talent?

	• What are the major employers the State competes with for employees?
	• What range (e.g., 90 to 110%) does the State wish to use to define "comparable" to the private sector, currently described in Section 2.2-1202 of the *Code of Virginia*? ○ Does the State wish to have different ranges for different job roles, career groups, or occupational families? Should the State provide above median total compensation for certain jobs?
	• What proportions of cash compensation and benefits does the State wish to provide as part of its total compensation package (e.g., 65% cash and 35% benefits and taxes)? ○ To what extent do the proportions (or choice among the proportions) of cash compensation and benefits need to differ for certain jobs or generations of the workforce?
Cash Compensation	• What is the purpose of annual performance increases, and should they be consistent with inflation and/or local, federal, or private annual salary increases?
	• Should the State pay its employees a salary sufficient to cover basic living expenses for a single adult in the locality where the employee works?
	• What role should salaries and bonuses play in motivating State employees?
Benefits	• What percentage of the workforce does the State wish to have enrolled in its health insurance plans?
	• To what degree does the State wish to subsidize the cost of health insurance for family members of employees?
	• At what point do out-of-pocket expenses hinder employee access to care?
	• What role should the State play in encouraging healthy lifestyles and the efficient use of health care?
	• What percentage of pre-retirement income should retirees receive, and should the percentage include the VRS benefit and Social Security benefits?
	• How closely should the VRS retirement ages be aligned with the qualifying ages for Social Security and Medicare?
	• What conditions should be met (e.g., increased average age of employees at retirement) before considering enhancing the current retirement benefits?

Source: JLARC staff analysis.

Commonwealth Needs a More Integrated and Analytic Approach to Total Compensation Decision-making

Articulating a total compensation strategy will require an integrated perspective across the elements of compensation and branches of government. Yet, no single organization is currently responsible for taking an integrated perspective across the purposes and spending associated with salaries, health insurance, retirement benefits, and leave. As emphasized throughout this report, an integrated perspective is critical to ensuring that the salaries and benefits the State offers achieve their intended purposes—but at a cost which is sustainable and efficient. Furthermore, the lack of information needed to conduct certain assessments, particularly as highlighted in Chapter 3 relating to employee salaries, underscores the need for enhanced analytic capability to help agencies, the Governor, and General Assembly better identify and address issues related to total compensation.

Employee Groups

In 2001, the General Assembly authorized the Virginia Human Resources Council, which is comprised of representatives appointed by the Governor and General Assembly. Other groups, notably the Virginia Governmental Employees Association and Virginia State Police Association, are critical to considering an employee perspective.

This more integrated and analytic approach could be achieved through more formalized interaction between the various entities with a role in total compensation decision-making, which could be supported by additional staff resources to conduct more rigorous analysis. Therefore, the General Assembly may wish to create a compensation advisory council, which would consist of the directors of DHRM, VRS, DPB, the House Appropriations Committee and Senate Finance Committee, and the Executive Secretary of the Virginia Supreme Court. The participants would serve without additional compensation, but resources as appropriate should be made available to facilitate coordination of the council's activities.

The council's role should build upon—rather than duplicate or supplant—the existing knowledge and expertise that resides within DHRM, VRS, DPB, and agency human resource offices. The council should be supported by additional staff resources, likely placed at DHRM and DPB. In addition to supporting the council, these staff should be tasked with providing additional analytical support to agencies that is necessary in certain cases. Depending on the level of expertise an agency human resource office has, this support may include consulting, assistance collecting employee survey data or market data, or guidance in developing budget requests.

The council's primary responsibilities would be to facilitate a comprehensive perspective across the elements of total compensation and branches of government; appropriately consider and balance agency and employee perspectives; and provide analytical rigor and transparency about (1) the supporting, objective facts indicating whether changes to salaries or benefits are necessary, (2) what changes should be made, if any, and (3) what the impact of the changes would be on the purposes of compensation, the State's financial risk, and employee and employer satisfaction. The council would report to the Governor and General Assembly annually on critical issues related to salaries and benefits, as well as provide analysis of the fiscal, operational, and human resource impact of proposed changes to total compensation during each legislative session.

The council could facilitate the development of the total compensation strategy described in Recommendation 2. After the completion of the strategy and its first report, the extent of the council's activities would be largely determined by whether objective analysis indicates that strategic changes to salaries and benefits should be considered.

Recommendation (3). The General Assembly may wish to create a compensation advisory council comprised of the directors of the Department of Human Resource Management (DHRM), Department of Planning and Budget (DPB), the Virginia Retirement System (VRS), the House Appropriations Committee, and the Senate Finance Committee, and the Executive Secretary of the Virginia Supreme Court. The council should be supported by a small staff of full-time analysts at DPB, DHRM, and VRS. The staff should provide analytic support and expertise that facilitate more purpose-driven, goal-oriented, and coordinated assessment of salaries and benefits. The General Assembly may wish to direct the advisory council to report annually on employee compensation and to provide analysis of the fiscal, operational, and human resource impact of proposed changes to compensation during each legislative session.

Chapter

3 State Salaries

In Summary

Salary is the largest element of compensation in terms of spending and the most important element to employees. Despite its importance, salary as currently provided is not the State's most effective recruiting, retention, and motivation tool. This is true in part because, according to Mercer, base salaries (for 43 job roles that were benchmarked during the study) are marginally competitive or are considerably below what other employers offer. Mercer also found that, in certain cases, refinements are needed to the current job role and pay band structure. Many employees are dissatisfied because their salaries are not competitive with the market and recent annual increases have not been adequate. JLARC staff found that more structure and rigor are needed in the budget process to determine whether a sufficient business case exists for targeted salary increases for employees in certain agencies, job roles, and geographic locations. JLARC staff and Mercer developed two options for consideration that would allocate funds for targeted salary increases in instances in which a sufficient business case exists.

Salary is the largest single element of total compensation the State provides. The State spent $3.3 billion on salaries for classified employees in FY 2007, which was about two-thirds of the State's total compensation spending. The study mandate directed JLARC staff to review the adequacy of salaries for State employees. This chapter assesses the adequacy of salaries against the purposes of recruiting, retaining, and motivating State employees. The chapter also addresses the job and pay band structure and the major reasons for employee dissatisfaction with current salaries. Finally, this chapter assesses the State's approach to considering whether agency requests for targeted salary increases should be funded.

JOB CLASSIFICATION AND PAY BANDS PROVIDE FLEXIBILITY, BUT MORE STRUCTURE IS NEEDED

An organization's job classification system is the foundation for many of its salary-related activities, including determining appropriate salary levels, comparing salaries to the market, analyzing pay equity, and controlling salary costs. The State's job classification system, described in Chapter 1, was last revised in 2000. At that time, the Commission on Reform of the Classified Compensation Plan recommended that the State reduce 1,650 job titles to 291 broader categories called job roles, and group these roles into career groups and occupational families. The State also consolidated the old system's 23 pay grades into nine broad pay bands. The commission's report indicates that agencies were to further refine the 291 job roles by using working titles, which are more specific than the job roles:

> The establishment of (job) roles will be managed at the central system level. Agencies will be able to define positions within a role by working titles. The use of working titles will facilitate recruitment efforts and more specifically describe the work performed by employees.

However, Mercer's assessment of the current job classification system found that

> The current role-based architecture lacks the specificity needed to identify jobs and career paths, limiting the ability to track market pay cost effectively, and contributes to attraction, retention, and motivation challenges.

Since the commission's report, it appears that agencies have further defined positions within job roles by working titles, in some but not all cases. Forty-four percent of classified employees do not have an assigned working title in the State's human resources information system. There is also a high degree of variation in the working titles included in certain job roles. For example, JLARC staff and Mercer found that

- Half of the 8,814 employees in the Administrative and Office Specialist III job role do not have working titles. The other half of employees in the job role are assigned 789 working titles. These 789 working titles vary widely and include Administrative Assistant, DMV Customer Service Generalist, Fiscal Technician Senior, Tax Examiner, and Buyer.
- Almost half (46 percent) of the 1,248 employees in the Financial Services Specialist I job role do not have working titles. The working titles that do exist within the job role suggest substantial differences in level of responsibility. For example, the role includes accountants and supervisors/managers of administrative support workers along with payroll and timekeeping clerks.

While the flexibility in the job classification system is necessary, the variation and, in some cases, lack of structure within job roles leads to at least two problems. First, according to Mercer, the variation among actual job duties and responsibilities within a job role makes it difficult to accurately compare salaries paid by the State to salaries paid elsewhere in the broader market. This is best evidenced by the fact that Mercer initially had difficulties benchmarking the State's job roles to similar jobs in the market because of the breadth of actual jobs performed within a job role. Consequently, Mercer and JLARC staff worked with DHRM to identify more specific occupations within job roles. Mercer then conducted its benchmarking using the most highly populated occupations within most job roles or those that best matched other positions that could be benchmarked. This important step facilitated more usable comparisons between State salaries and the broader market, but also illustrates the limitations of the current job roles without further definition.

UVA's Market Ranges

As part of its transition away from the classified system, the University of Virginia has developed market-relevant ranges for each job within broader pay bands. The ranges are determined by factors including required qualifications and employee capabilities. An employee's pay within a market-based range will be determined based on career capabilities including such factors as skills, training, experience, education, behavioral characteristics, and performance.

Second, the job roles and corresponding pay bands on their own do not provide sufficient guidance for agencies to make salary decisions. Agencies that have not created additional structure within the job roles and pay bands to help them determine pay could be underpaying or overpaying employees. For example, the Administrative Office Specialist III job role described above is in pay band three, which ranges from $23,999 to $49,255. Grouping employees performing varying types of work within a single job role, where appropriate, and allowing agencies to set salaries with such a wide pay range places the burden on agencies to determine the appropriate starting salary and subsequent salary increases.

Based on the examples above, it is likely there are job roles for which further structure is necessary to provide more guidance to agencies about what to pay employees—as well as provide confidence that State salaries are appropriate. However, attempting to rationalize the structure within all 291 job roles simultaneously is neither feasible nor necessary. Therefore, DHRM should identify agencies that believe they have job roles needing further refinement. These agencies should collaborate to determine whether greater structure is needed within the job role and if so, proceed with creating additional structure. In some cases, agencies have already worked with DHRM to develop additional structure where necessary. However, there are other agencies and/or job roles where more structure is needed. Candidates for this needed additional work would ideally be job roles that include a substantial

Recommendation (4). The Department of Human Resource Management (DHRM) should work with selected agencies to provide further structure and guidance in the classification system and pay bands, where appropriate. This could be accomplished by creating additional structure within job roles that have substantial variation among working titles, better articulating career paths or levels (for example, management, professional, technical, or support) within or across job roles, and/or creating new occupational families, career groups, or job roles. DHRM and selected agencies should work together to identify the specific job roles in need of further structure. These agencies should also collaborate as necessary to create additional structure and/or provide more guidance about what to pay employees within the existing pay bands.

number of employees, have a high number of working titles or missing titles, and large variation among the titles, such as Administrative and Office Specialist, Financial Services Specialist, or Program Administration Specialist.

SALARY IS NOT STATE'S MOST EFFECTIVE RECRUITMENT, RETENTION, AND MOTIVATION TOOL

According to DHRM, the State's compensation philosophy is to "pay employees in a manner sufficient to support and develop a high performance workforce that provides quality services in a fiscally responsible manner to the citizens of Virginia." The specific goals identified to support this philosophy are to

- attract qualified employees,
- retain qualified employees,
- motivate employees by rewarding sustained performance, and
- support management in the realization of organizational objectives.

However, JLARC staff analysis indicates that the current approach to salaries is only partially achieving these goals.

Salary Is Not State's Primary Recruitment and Retention Tool

Despite the magnitude of the State's expenditures for salary and its importance to employees as noted in Chapter 2, most employees said that salary was not the primary reason they work for the State. Only nine percent of employees responding to the JLARC staff survey of classified State employees indicated salary was the primary reason they chose to work for, and subsequently stay with, the State. Furthermore, only 36 percent of employees responding to the survey agreed that their salary was an attractive part of the compensation package. However, as noted in Chapter 2, salary was the largest single reason employees left their job in FY 2008. Collectively, this evidence suggests that salary is not the State's most effective recruiting and retention tool, and in many cases hinders agency efforts to build and maintain a workforce.

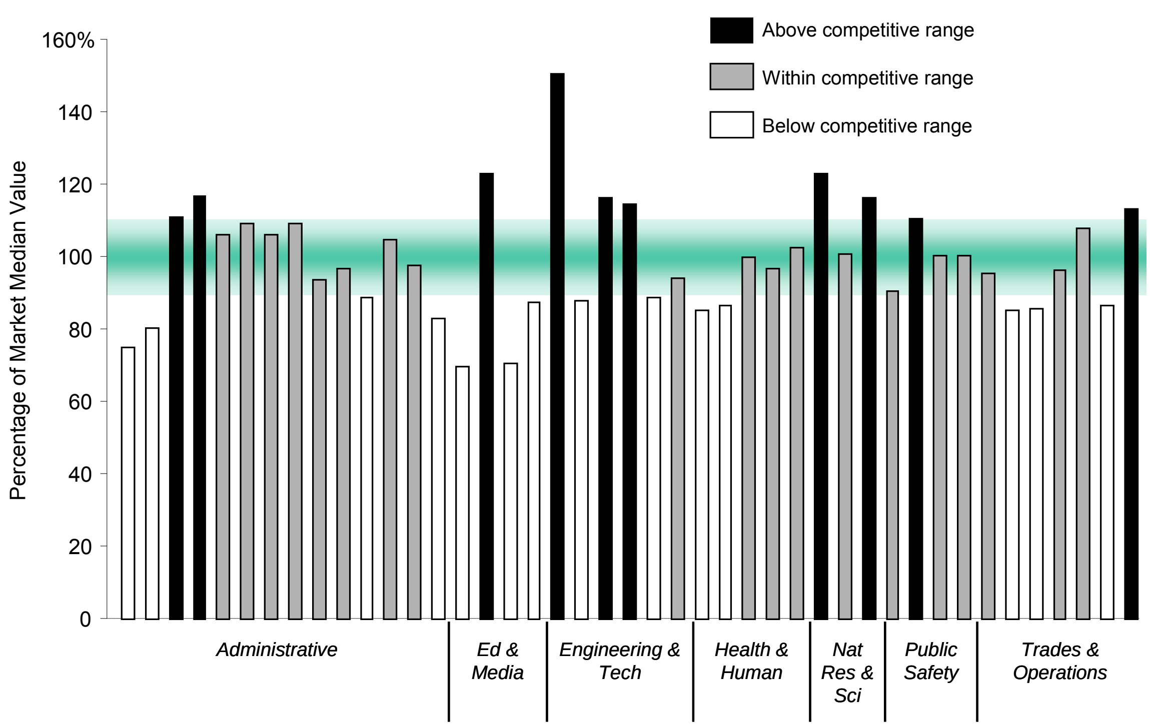
In fact, of the 35 agencies that reported compensation-related recruitment and retention problems, most cited non-competitive salaries and minimal salary increases as the cause. Agencies such as the Department of Transportation and DMHMRSAS, and facilities such as Fluvanna Correctional Center reported that salaries were the main cause of their recruiting and retention problems. Other agencies reported that salary played a role in their recruiting and retention challenges, but the primary causes were other factors such as difficult working conditions or poor management.

Mercer Found That Recruitment and Retention Are Likely Hindered by Marginally Competitive Salaries

Much of what makes the State's salaries a less than effective recruiting and retention tool is that they tend to be below the median market salary. As noted in Chapter 2, JLARC staff and Mercer collaborated with DHRM to identify 43 representative job roles across all seven occupational families. Mercer then calculated a base salary and total cash compensation (base salary plus bonus) index.

Mercer found that the base salaries for employees within these 43 job roles, on average, ranked at 92 percent of the market median, but competitiveness varied significantly by job role. As shown in Figure 9, 19 (or 44 percent) of the 43 job roles examined were between 90 and 110 percent of the market median (only three of these roles were less than 95 percent of the median). Another ten job roles were more than 110 percent of the market median, resulting in 29 roles, or about two-thirds of the benchmarked job roles,

Figure 9: Base Salary Index for 43 Job Roles



Source: JLARC staff analysis of Mercer data, 2008.

having base salaries that were in the competitive range or above. The remaining 14 job roles were compensated at less than 90 percent of the market median. For one of these job roles (Education Support Specialist II) the average salary was almost 35 percentage points below the median for comparable positions.

There also appears to be a relationship between employee tenure and the competitiveness of their base salary. Mercer found that the base salary for employees in the benchmarked job roles with less than one year in their current job role were, on average, below a competitive range at 86 percent of the market median. By contrast, base salaries for employees with 15 years or more in their job role were 102 percent of the market median.

Mercer found that the State's overall relative position falls from 92 percent on base salary to 88 percent on total cash compensation (salaries plus bonuses). This is because of the lower value of bonuses the State provides compared to other employers. Most of the job roles become less competitive when examining total cash compensation rather than base salary alone. One job role in particular dropped substantially: the Security Officer III job role drops from 100 percent of the median for base salary to 85 percent of the median for total cash. This indicates that employees performing similar work for other employers are eligible for larger bonuses than what the State typically provides.

Salary Is Partially Effective at Motivating Employees

Many factors other than salaries motivate employees, including opportunities for interesting and challenging work, work environment, and career opportunities. Nevertheless, a minority of agencies and employees felt that salaries are an effective motivation tool. Only one-third of State agencies agreed that the compensation they offer allows them to motivate employees. The majority of agencies who reported difficulty motivating employees cited salary as the main compensation-related reason. Similarly, only 23 percent of employees agreed that their current salary motivates them to efficiently and effectively perform their job responsibilities—40 percent disagreed. Employees at the State's mental health facilities and training centers were somewhat more likely to report that their salary does not motivate them. Forty-seven percent of these employees disagreed that salary motivated them, compared to 42 percent of correctional facility employees and 39 percent of higher education employees.

HALF OF EMPLOYEES DISSATISFIED WITH THEIR SALARIES

Nearly 11,000 employees responding to the employee survey reported they were dissatisfied with their salaries; 16 percent of these employees were very dissatisfied. The most frequently cited reasons were uncompetitive salaries, inadequate annual increases, or issues related to salary compression. Some employees also were dissatisfied because they cannot afford their basic living expenses.

Employee Dissatisfaction Due to Uncompetitive Salaries Is Understandable in Certain Cases

Forty-seven percent of employees were dissatisfied with their salaries because they believed their salaries are not competitive with what other employers offer. Based on the Mercer benchmarking of State salaries to other employers, some employee dissatisfaction due to uncompetitive salaries is explainable. While two-thirds of the benchmarked job roles were paid salaries within a competitive range or higher, the remaining third were not.

JLARC staff compared the Mercer benchmark data to the level of employee dissatisfaction for selected job roles. There are job roles that reported higher-than-average dissatisfaction and also were benchmarked as having below-market salaries, but there are also job roles that reported higher-than-average dissatisfaction yet have above-market salaries. The wide variation within a job role described earlier in this chapter, along with the fact that the Mercer benchmarking is based on averages, hinders the ability to compare individual employee dissatisfaction with how individual salaries compare to the market.

Other Types of Salary Increases Provided by the State

In addition to annual performance increases, the State has also increased employee salaries in other ways over the years. In 2005, most employees received a base increase of $50 for each completed year of continuous salaried service in addition to the annual increase. In 1984, the State paid the employee life insurance premium, which equaled one percent of pay. In 1983, the State began paying the five percent member contribution into VRS on behalf of employees, which DHRM estimates equaled a seven percent increase in take-home pay because the contribution was pre-tax.

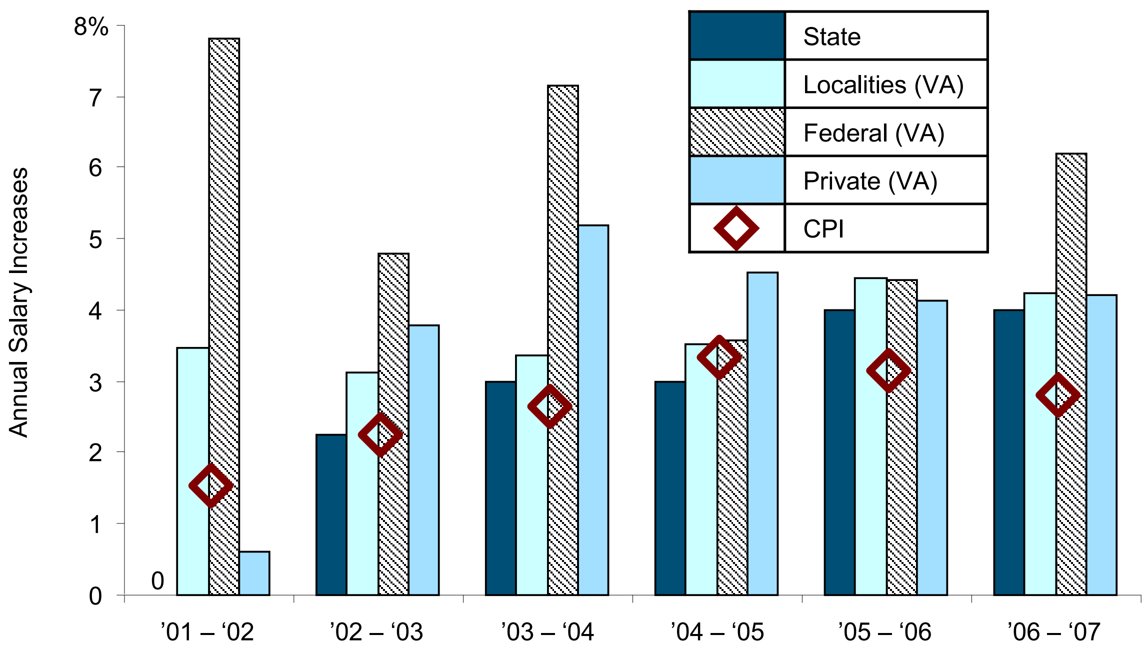
Employee Dissatisfaction With Annual Salary Increases Is Understandable When Compared to Other Government and Private Sector Increases in Recent Years

Forty-two percent of employees were dissatisfied with their salaries because they believed their annual salary increases were not adequate. These annual increases, which are proposed by the Governor and approved by the General Assembly, are designated as performance increases; all employees who receive a “contributor” rating or higher on their performance evaluation receive the increase. While it is difficult to assess these increases in the context of each employee’s individual performance, it is possible to compare these salary increases to the Consumer Price Index (CPI) and other employer increases.

Since 1975, the cumulative (non-compounded) annual State salary increases have outpaced the CPI by about 38 percent, suggesting that the annual increases have more than kept pace with the cost of living over the long term. When measured more recently, the State increases are slightly above the cumulative increase in CPI, though they vary in any given year when compared to the CPI. Since 1990, the annual State salary increase totaled 55 percent, slightly above the CPI increase of about 52 percent. Since 2000, State increases totaled 19.5 percent, slightly below the CPI increase of 22 percent.

However, comparing annual salary increases to what other employers have provided in recent years explains employees' dissatisfaction. As shown in Figure 10, State increases have been lower than the federal government, Virginia local governments, and Virginia private employers in each of the six years between 2001 and 2007.

Figure 10: State Annual Salary Increases Less Than Other Employers Since 2001



Note: There were no State salary increases in 2001-2002.

Source: JLARC staff analysis of DHRM and Bureau of Labor Statistics data, 2001 -- 2007.

Salary Is Not Sufficient to Cover Basic Living Expenses for Some Employees

Though not among the most frequently cited reasons for dissatisfaction with salaries, approximately 1,800 of employees responding to the JLARC survey of classified State employees reported being dissatisfied because their pay does not allow them to afford basic living expenses (food, housing, transportation, child care, and

The Self-Sufficiency Standard

The self-sufficiency standard represents the amount of money working adults need to meet their basic needs without subsidies of any kind. The standard covers only immediate, day-to-day necessities, such as housing, food, transportation, and health care, and excludes longer-term needs. For a single adult, the standard ranges from a low of $13,894 a year in Scott County to a high of $31,521 in Manassas Park (2006 standard inflated to 2007 dollars).

health care). Based on a JLARC staff comparison of the actual salaries paid to each full-time classified State employee against the self-sufficiency standard for a single adult in the locality where their agency is located, the dissatisfaction expressed by a small but concentrated group of employees is understandable.

Nearly 1,500 classified State employees earned less than the self-sufficiency standard for single adults in their locality in 2007. Ninety percent of these employees were either Direct Service Associates, Housekeeping and/or Apparel Workers, Food Service Technicians, or Administrative and Office Specialists. Almost three-quarters of the employees making below the standard for single adults are located in five localities: Fairfax, James City, and Dinwiddie counties, and the cities of Chesapeake and Norfolk. Fairfax and James City counties have the most employees making below the standard (Table 7). Thirteen percent of State employees located in Fairfax County are paid below this standard, as are 20 percent of those located in James City County. Some employees are making at least 20 percent below the self-sufficiency standard and a few are as much as 35 percent below the standard. In Fairfax County, for example, 81 employees make 20 percent less than the standard and 15 employees make 30 percent less than the standard.

Table 7 also shows that it would cost $3.4 million to bring the employees in these 11 localities up to the self-sufficiency standard for their locality. Closing the gap between actual salaries and the self-

Table 7: Largest Number of Employees Paid Less Than Self-Sufficiency Standard Are Located in Fairfax County

Locality[a]	Self-Sufficiency Standard for a Single Adult in Locality	State Employees in Locality Paid Below Self-Sufficiency Standard		Additional Salary Needed to Achieve the Self-Sufficiency Standard
		#	*% of Total Employed in Locality*	
Fairfax County	$30,478	404	13%	$1,554,145
James City County	23,487	216	20	463,870
Dinwiddie County	19,716	176	7	496,701
Chesapeake	22,177	175	12	370,326
Norfolk	19,905	123	5	194,923
Newport News	20,382	62	7	67,537
Williamsburg	21,481	52	7	37,369
Virginia Beach	24,288	41	6	104,156
Chesterfield County	23,049	32	1	36,504
Fredericksburg	23,847	29	5	57,339
Loudoun County	31,388	25	7	29,149
				$3,412,019

[a] Localities with 25 or more employees making less than the self-sufficiency standard.

Source: JLARC staff analysis of 2007 salary data from DHRM and self-sufficiency data from Voices for Virginia's Children.

sufficiency standard for employees making below the standard in other localities would cost an additional $244,307, for a total of $3.66 million to bring all State employees up to the self-sufficiency standard for single adults in their locality.

Lack of Structure Within Job Roles Makes It Difficult to Validate Dissatisfaction Due to Salary Compression

Salary compression occurs when newly hired employees are paid salaries that are similar to, or greater than, more experienced employees who perform the same job. Thirty-five percent of employees who were dissatisfied with their salaries cited that new employees with less experience make the same as, or more than, they do. Sixty-one percent reported being dissatisfied because they felt their salary was not adequate considering their experience and work responsibilities.

Agencies also cited salary compression as a concern. More than half of the agencies responding to the agency survey reported that salary compression exists in their agency. Of those, 64 said that it reduces employee morale and motivation, 51 said it makes existing employees resent new hires, and 42 said existing employees leave the agency for another job. More than half of the 32 agencies that reported they have motivation problems to a great extent say that salary compression is the reason.

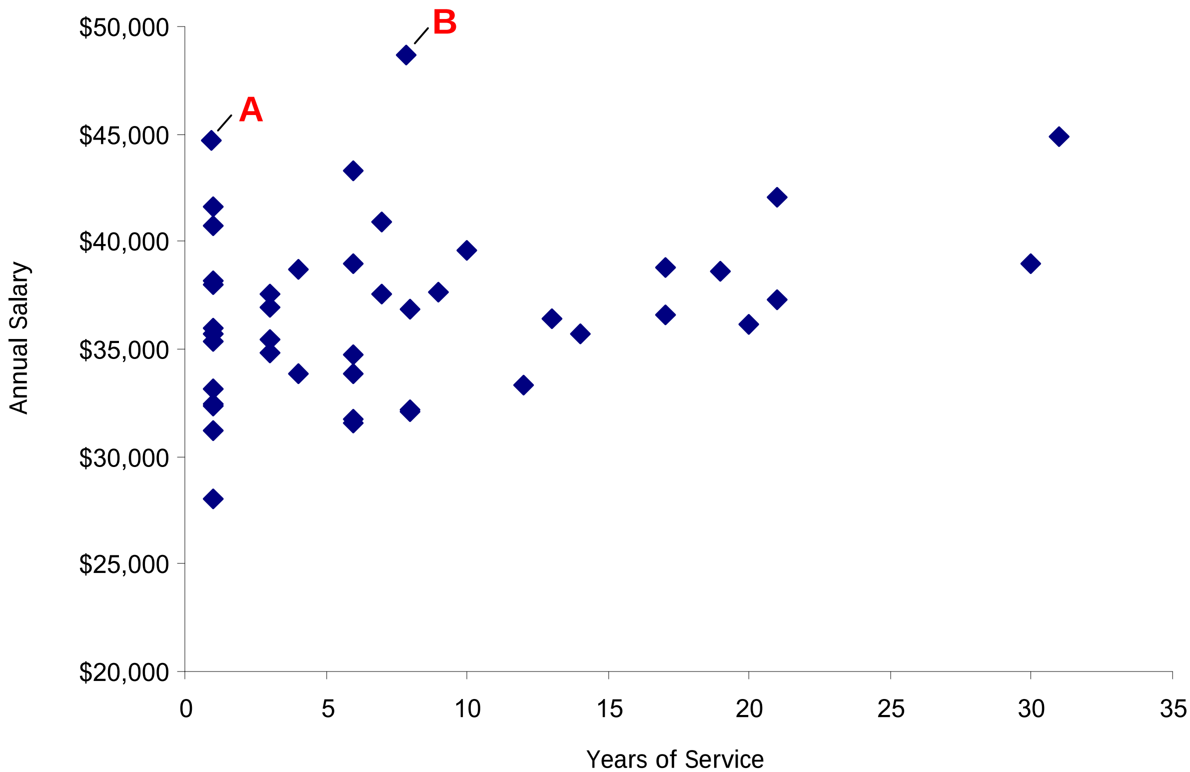
Recent Initiatives to Address Salary Compression

In the past three years, the State has twice attempted to address salary compression. In 2005, employees rated "Contributor" or higher (with more than five years of service) received a base increase of $50 for each completed year of continuous salaried service. In 2006, agencies were given 0.5 percent of their payroll budget to help them fund pay practices. Many agencies used this funding to address pay compression issues, underscoring that tools are available to address salary compression.

Though it is difficult to measure, salary compression can in certain cases be detected if there are very minimal differences in the salaries paid to employees who have substantial differences in years of experience. One example of potential salary compression can be found in the Administrative and Office Specialist III job role at one State agency. The difference between the actual salaries paid employees with less than one year of service and those with between one and five years of service differ by less than one percent—or $292 per year. This minimal difference translates into about $12 per paycheck before taxes.

Employees rarely know the salaries paid to each of their colleagues and how the average varies by tenure. Yet, even a single known instance in which a new employee is paid higher than more experienced employees can create the perception that salary compression is a problem. Figure 11 shows the actual salary and years of service of each Administrative and Office Specialist III at this agency. Note the data points representing the salaries and years of service for the two employees labeled “A” and “B”:

Figure 11: Example of Potential Pay Compression Among Administrative and Office Specialist IIIs at One State Agency



Source: JLARC staff analysis of DHRM Personnel Management Information System data.

- Employee A had less than one year of experience in the job role but makes more than all but two of the other Administrative and Office Specialist IIIs in the agency, most of whom have many more years of experience.
- Employee B had just under eight years of experience in the job role and the highest salary of all the Administrative and Office Specialist IIIs in the agency. This employee makes more than 16 employees who have more years of experience in the job.

These examples, if known to other employees in the job role, likely would create the perception of salary compression. However, there may be valid reasons why employees with fewer years of service make about the same as, or more than, more experienced employees. For example, the newly hired employee may have more experience from a previous employer or more education. Certain longer-tenured employees also may not have received salary increases because of poor performance in the past.

The lack of structure within certain job roles noted earlier in this chapter makes it more difficult to evaluate whether salary compression exists in any particular job role. Because there may be a wide variety of types of work performed within a job role, employees may be comparing their salaries to other employees who are in the same job role but are actually doing different jobs. The job structure also makes it difficult for agencies to determine the extent to which salary compression exists. Salary compression is only relevant among employees performing very similar duties, yet the variation among working titles (or absence of them) makes it difficult to be certain that the salaries being compared are paid to employees performing similar jobs.

MORE COMPREHENSIVE AND DETAILED INFORMATION NEEDED TO DETERMINE PRECISE EXTENT OF ADDITIONAL FUNDS NECESSARY FOR SALARY INCREASES

As noted in Chapter 2, multiple factors influence employees' decisions to work for the State. By extension, the decision about whether additional funds are needed to improve the extent to which salaries achieve the purposes of recruiting, retention, and motivation requires considering a variety of factors. For example, while an agency may have difficulties recruiting and retaining certain employees, salaries may not be the primary reason for the challenges. Additionally, though employees may not be paid at the market median and there may be dissatisfaction with salaries, it may not be prudent to increase salaries if the State is not experiencing recruiting and retention challenges, and if the State is content with the caliber of employees performing the job.

To gain additional perspective about the complexity surrounding the decision to provide additional funds for salary increases targeted to specific groups of employees, JLARC staff examined requests for salary increases that agencies made during the FY 2009 budget process.

Agency Requests for Salary Increases Lacked Sufficient Information to Adequately Assess Need for Additional Funds

Each year during the budget process, the Department of Planning and Budget (DPB) and DHRM collaborate to consider agency requests for additional funds for salary increases to certain groups of employees. When asked about this process, DPB indicated that the complex set of factors that impact an agency's ability to recruit, retain, and motivate its employees—along with information gaps in agency requests—make it challenging at times to fully consider and assess agency requests. These information gaps are likely due in part to the fact that the current budget documentation provides minimal guidance to agencies that submit budget requests for salary increases. The budget request form asks agencies to describe the need for the requested funds, whether a key objective or performance measure will be impacted by the request, the consequences of not funding the request, alternatives considered, expected results to be achieved, and cost. DHRM indicated they provide additional guidance to agencies on an ad-hoc basis and in certain cases work with agencies to make the request.

As a result of the various activities undertaken during this study, JLARC staff identified three key areas that appear to be relevant when considering whether additional funds are necessary for employee salaries: (1) the extent to which salary is achieving its purposes of recruiting, retaining, and motivating employees, (2) how current salaries, bonuses, and benefits compare to what other employers provide, and (3) what impact the inability to recruit, retain, and motivate employees has on the agency and taxpayers. Addressing these three key areas would make it clear whether or not a "business case" exists for providing increased funds. This business case would be based on the assumption that a targeted investment in funding for employee salaries would yield enhanced value through program improvement and/or cost avoidance.

Given DPB's assertion that it is at times challenging to assess agency requests for increased funds for employee salaries, JLARC staff reviewed the 12 budget decision packages for salary increases submitted by agencies to DPB during the most recent budget cycle. JLARC staff assessed each budget decision package (after the budget process had concluded) against specific criteria identified by JLARC staff in each of the three key areas (Table 8). This

Table 8: Few FY 2009 Budget Decision Packages Requesting Salary Increases Provided Data Necessary to Address Three Key Areas Identified by JLARC Staff

Budget Decision Package	1. Salary Achieving Purposes	2. How Total Compensation Compares to Other Employers	3. Impact of Inability to Achieve Purposes
A	○	◐	○
B	◐	○	○
C	◐	◐	○
D	○	◐	○
E	○	○	○
F	○	○	○
G	○	◐	○
H	○	○	○
I	○	○	○
J	◐	◐	◐
K	○	○	○
L	○	○	○

Legend	● Most Data Provided	◐ Some Data Provided	○ Little or No Data Provided

Source: JLARC staff analysis of FY 2009 decision package narrative justifications.

assessment found that while most agencies answered the questions on the budget request form, few of the agencies provided sufficient information to address the three key areas identified by JLARC staff. Most of the requests, for example, described in general terms how the agency was having problems retaining staff and how their salaries were below market. However, in nearly all cases no specific data or evidence to support these claims was provided along with the package, though the agency may have had additional information that it did not provide along with the budget request or that was relayed through other means during the budget process.

Collecting Data to Address Three Key Areas Helps Assess Whether Business Case Exists for Salary Increases

To further test the concept that collecting data to address the three key areas identified above can help decision-makers assess whether a business case exists for salary increases, JLARC staff also applied this same criteria to the Direct Service Associate II job role at Northern Virginia Mental Health Institute (NVMHI). This job role was one of several jobs at NVMHI and Northern Virginia Training Center that were included in budget amendment requesting salary increases. Rather than being included in the budget, this amendment was referred to JLARC staff by its patron for consideration during this review. As shown in the case study below, there is information in each of the three key areas that, in totality, makes a fairly compelling business case for increasing salaries for Direct Service Associate IIs at NVMHI.

> ***Case Study***
>
> *<u>1. Salary does not appear to be achieving its purposes</u> - The turnover rate for Direct Service Associate IIs at NVMHI is slightly above average at 12 percent and is exacerbated by a nine percent vacancy rate. Over 80 percent of the Direct Service Associates at NVMHI make less than the self-sufficiency standard, which can lead to motivation problems, in addition to recruitment and retention problems. Data from agency interviews and the employee survey indicate that salary is a major reason for their recruiting and retention problems; one-third of Direct Service Associates resign because of salary, one-third of job candidates do not accept job offers because of salary, and one-third of employees who take pay cuts to work at NVMHI resign within the first year.*
>
> *<u>2. Current Direct Service Associate salaries at NVMHI are likely below other employers in the area</u> - Mercer benchmarked statewide Direct Service Associates II salaries at 86.6 percent of the statewide median. The median salary for*

Direct Service Associates IIs ($26,643) at NVMHI is actually below the statewide market median for Direct Service Associates IIs ($27,481). This fact, when combined with the likelihood that the salaries paid by competitor employers around NVMHI are higher than the statewide median, suggests salaries for Direct Service Associates IIs at NVMHI are considerably below the market.

<u>3. Inability to achieve purposes hinders agency performance and results in unnecessary expenditure of taxpayer resources</u> - Overtime and employee replacement costs for Direct Service Associates IIs at NVMHI were estimated at $500,000 for 2007. The original budget amendment requested $339,000 to increase the salaries of these employees, which is $160,000 less than the agency's combined overtime and replacement costs for this job role in 2007. Assuming that overtime and replacement costs would decrease to some degree if salaries were increased, the agency could potentially save money by investing in a salary increase for these employees.

In addition, turnover and vacancies have a negative impact on patient care, according to the NVMHI director. In the past, NVMHI has been a leader in preventing and managing behavior emergencies without using patient seclusion or restraint. However, as vacancies and turnover have increased, the use of seclusion and restraint has also increased. Less experienced staff are less likely to recognize the signs of patient agitation/aggression, so they may be unable to stop the behavior before it escalates, leading to the need for seclusion and/or restraint. This also contributes to increases in staff injuries and patient frustration levels.

This case study illustrates that considering the three key areas is instructive when deciding whether additional funds are necessary for salaries. Furthermore, in this case it appears that targeted salary increases may improve the agency's ability to recruit and retain staff, and could potentially result in cost avoidances and improved program performance.

Data-Driven "Pay for Purpose" Approach Is Needed to Determine Extent of Additional Funds for Salary Increases

As shown in Table 9, the State's current approach to salaries is partially achieving the purposes of recruiting, retaining, and motivating employees. Broadly speaking, the State appears able to recruit and retain a workforce and the salaries paid are marginally competitive with what other employers provide. However, as noted

Table 9: Summary Assessment of Current Approach to Salaries

	Purposes			Cost	
	Recruit	*Retain*	*Motivation & Morale*	*Current $*	*Future $ Risk Level*
Salary	◐	◐	◐	$3,301 Million	Low

Legend for Scale of Purpose Achieved | ● Mostly | ◐ Partially | ○ Minimally

Source: JLARC staff assessment, 2008.

Pay Factors to Determine Salaries

Agencies assess the adequacy of salaries for each employee using a set of 13 pay factors. These factors include job-based factors (agency need, and duties and responsibilities), employee-based factors (performance, work experience, knowledge and skills, training, internal salary alignment, current salary), market factors (market availability, salary reference data, and total compensation), and financial factors (budget implications and long-term impact).

in Chapter 2 and further illustrated in this chapter, there are instances in which agencies are struggling to recruit and retain a workforce and salaries provided to certain job roles that are considerably below the market median. Various issues lead to a large number of employees not being motivated by salaries and dissatisfied with what they are paid.

Though salary is the State's largest element of total compensation spending, it does not—unlike health insurance and retirement spending—present a high level of future financial risk because the General Assembly and the Governor control the amount of annual salary increases each year.

This summary assessment of salaries suggests that in certain cases targeted salary increases would likely improve the State's ability to recruit, retain, and motivate employees. These increases need to be targeted to specific agencies, job roles, and geographic locations. However, the lack of sufficient information to adequately assess whether a business case exists for increasing salaries makes it challenging to identify with a high degree of confidence which employees (in which job roles, agencies, and geographic locations) should receive targeted increases. Importantly, substantially increasing salaries for all employees is not a prudent expenditure of State funds because in certain cases salary is achieving its purposes and is competitive with what is provided in the market.

This more targeted approach would not be in lieu of annual performance increases …

Consequently, a more targeted and data-driven approach is needed to determine whether additional funds are warranted for targeted salary increases for selected groups of employees. This more targeted approach would not be in lieu of annual performance increases, but rather provide more rigor to the consideration of whether one-time increases are needed for employees in certain job roles, agencies, and geographic locations. This approach could be labeled "pay for purpose" because, if implemented, it would better identify instances in which a business case for salary increases does exist, thereby highlighting instances in which the purposes of recruiting, retaining, and motivating employees could be better achieved.

The "pay for purpose" approach is accomplished primarily through changing the decision packages used by DPB to address the three key areas identified previously. The ten criteria JLARC staff have identified in the three key areas are shown in Exhibit 4. Requests that provide information that satisfactorily addressed the criteria would give the General Assembly and Governor sufficient confidence that there is a business case for targeted salary increases. Requests that did not address the criteria, or requests that had gaps in information necessary to determine if the criteria were addressed, would result in either a lower degree of confidence that a business case exists or a determination that more information needs to be submitted.

Making such a change to the current decision package and supporting process would have four primary advantages over the current approach. First, it would create a standardized framework to

Exhibit 4: Criteria to Determine Whether Targeted Salary Increases Would Improve State's Ability to Achieve Its Purposes

Salary Achieving Purposes	1. Is the agency experiencing long-standing recruitment and retention challenges for the job role that are substantially above the State average or desired level? 2. Does the agency expect challenges recruiting and retaining employees in the job role in the future? 3. Is the agency experiencing challenges motivating employees in the job role to adequately perform their work responsibilities and/or are employees expressing dissatisfaction with salaries? 4. Is there strong evidence to suggest that salary issues play a major role in the job role's recruitment, retention, or motivation challenges?
How Total Compensation Compares to Other Relevant Employers	5. Are the current salaries for the job role in which recruiting and retention challenges exist substantially less than the relevant market? 6. Is the difference in salaries still substantial when accounting for other factors, including benefits and work environment?
Impact of Inability to Achieve Purposes	7. Is there a substantial financial cost to replacing employees who are hired and leave shortly thereafter? 8. Is there a substantial financial cost attributable to having employees work more hours to compensate for staff vacancies and/or high staff turnover? 9. Are there other costs attributable to the agency's current recruitment, retention, and/or motivation challenges? 10. Is there a documented relationship between recruitment, retention, and/or motivation challenges (attributable to salary) and reduced agency ability to achieve its mission or operate efficiently and effectively?

Source: JLARC staff analysis.

determine whether or not salaries in specific instances need to be increased to better achieve the purposes of compensation, and/or better achieve agency goals and objectives. Second, it would provide agencies more specific guidance about what information they would need to compile to sufficiently justify proposed salary increases. Third, it would provide DPB, DHRM, the Governor, and the General Assembly with sufficient information to adequately assess (1) whether or not a targeted salary increase is a prudent and justifiable expenditure, and (2) how the requested increase should be weighed and prioritized during the budget process. Most importantly, the "pay for purpose" approach would have a positive impact on employee recruitment, retention, and motivation if it is properly implemented and funded.

The recommendation below to implement the pay for purpose approach could be piloted in selected instances prior to full implementation to refine the process. In addition, certain agencies will likely need assistance in preparing budget requests using the pay for purpose approach, particularly with conducting market surveys and calculating employee replacement costs. This assistance should be provided through the increased analytical capability as part of Recommendation 3 in Chapter 2.

Recommendation (5). The Department of Planning and Budget should revise its Decision Package Narrative Justification form to require agencies requesting additional funds for employee salaries to address the extent to which current salaries are recruiting, retaining, and motivating employees; how total compensation compares to what is offered by other relevant employers for similar positions; and the impact on the agency's inability to provide services and recruit, retain, and motivate employees.

OPTIONS TO IMPROVE RECRUITING AND RETENTION THROUGH TARGETED SALARY INCREASES

These options would be in addition to the performance increases the General Assembly and the Governor decide to grant to employees in a given year.

To illustrate how the pay for purpose approach could be implemented, JLARC staff identified two options. These options would be in addition to the performance increases the General Assembly and the Governor decide to grant to employees in a given year. Both options entail employing the pay for purpose approach recommended above to prioritize the instances in which targeted salary increases could be provided. Prioritization of funding would be based on budget requests that could be segmented into two tiers. This segmentation would be based on the extent to which each request addresses the ten criteria to determine whether targeted salary increases would better achieve the State's purposes.

The first tier of budget requests would be those that fully address most, if not all, of the ten criteria shown previously in Exhibit 4. These first tier budget requests would make the most compelling and clearly documented case to provide additional funds for targeted salary increases. Second tier requests would either fully or partially address many of the criteria. These second tier requests would make a case for additional funds, but would be less compelling and/or less documented when compared to those in the first tier. Discretion would be necessary when evaluating budget requests because each of the criteria would not necessarily carry equal weight. An illustrative example of how such as approach could be applied is shown in Table 10.

Table 10: Illustrative Example of Application of Pay for Purpose Approach to Agency Budget Requests for Increased Funding for Salaries

	Criteria	Illustrative Information Needed to Assess Agency Budget Requests Against Criteria	Extent to Which Budget Request Addresses Criteria	
			First Tier	*Second Tier*
Salary Achieving Purposes	1	• Turnover rate	●	●
		• Vacancy rate	●	●
		• Length of time to fill vacant positions	●	●
	2	• Projected retirement rate	●	◐
		• Projected future workforce trends (e.g., projected shortage of workers with necessary skills relative to projected need)	◐	○
	3	• Interviews with agency management	●	◐
		• Employee survey results	●	●
		• Documented evidence of salary compression	●	◐
		• Salaries below self-sufficiency standard	●	○
	4	• Employee exit survey results	●	●
		• Analysis of why salary is cost-effective method to better achieve purpose (e.g., if challenges are more directly related to non-compensation or non-work issues)	●	◐
How Total Compensation Compares to Other Relevant Employers	5	• Benchmark data that compares salaries to relevant employers in relevant market	●	●
	6	• Information about benefits and work environment for relevant employers in relevant market	◐	○
Impact of Inability to Achieve Purposes	7	• Estimates of replacement costs (e.g. staff time, advertising, costs to train employees who leave after being trained)	●	◐
	8	• Estimates of costs due to increased work hours for existing employees to cover vacant positions (e.g., overtime expenditures, compensation leave awarded)	●	●
	9	• Estimates of costs to hire private contractors to do work not done by agency because of vacancies or turnover, loss of federal matching funds, etc.	○	◐
	10	• Documented evidence of how changes in agency performance are associated with changes in ability to recruit, retain, and motivate employees	●	◐

Legend for Scale of Extent to Which Request Addresses Criteria | ● Fully Addressed | ◐ Partially Addressed | ○ Not Addressed

Source: JLARC staff analysis.

The funding required would likely be used to increase base salaries in many instances. However, retention bonuses and other pay practices that are available to agencies would also play a key role in addressing agency recruiting, retention, and motivation challenges. It is likely, therefore, that some portion of the funds necessary in both options could be designated toward pay practices.

As noted earlier in this chapter, there is currently insufficient information for JLARC staff to determine the agencies, job roles, and geographic locations where targeted salary increases should be provided. By extension, there is also insufficient information to determine how much funding is required to provide those increases. Until this information is developed, it is unclear how much funding would be required. In the absence of this information, however, JLARC staff have identified a moderate and more aggressive option to implement the pay for purpose approach. These options are illustrative because it is unclear exactly how much funding would eventually be required to fully address the first and second tier budget requests.

Finally, as noted in Chapter 1, many of the benefits the State provides are based on an employee's salary. Consequently, increases in salaries also result in higher benefit costs. The largest of these benefit costs include payroll taxes for Medicare and Social Security, the employer and employee contribution into the Virginia Retirement System, and contributions towards disability coverage under the Virginia Sickness and Disability program. In 2008, the benefits based on employee salaries totaled 22.8 percent of salary. This additional amount is factored into the cost estimates for the salary options below.

Option S1: Moderate Implementation of Pay for Purpose Approach to Fund First Tier Budget Requests

As noted earlier in this chapter, Mercer benchmarked the total cash compensation provided to State employees at 88 percent of the market median. The assumption for the funding needed for moderate implementation of the pay for purpose approach is based on increasing total cash compensation, on average, to 90 percent of the market median. Given that the State spent $3.3 billion on total cash compensation in FY 2007, it is estimated that the two percent increase in total compensation necessary to achieve 90 percent of the median would cost approximately $66 million.

This $66 million would be applied to the agency requests for increased salaries that are designated as first tier through the pay for purpose approach. Allocating the funds in this way would likely improve the State's ability to recruit, retain, and motivate employees in the appropriate agencies, job roles, and geographic locations where improvement is most prudent.

This level of targeted salary increases would also increase benefit costs by an additional $15 million. This estimate could be lower depending on how much funding is used for pay practices that do not increase base salary, such as retention bonuses. The total estimated annual cost in the first year of this option's implementation would be approximately $81 million (Table 11).

Table 11: Summary Assessment of Potential Impact of Option S1

	Purpose			**Cost**	
	Recruit	*Retain*	*Motivation & Morale*	*Projected Cost*	*Future $ Risk Level*
Moderate Pay for Purpose (S1)	↑	↑	↔	$81 million	Higher

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful

Source: JLARC staff assessment, 2008.

Option S2: Aggressive Implementation of Pay for Purpose Approach to Fund First and Second Tier Budget Requests

The State could also take a more aggressive approach to implementing the pay for purpose approach that would include the first tier in option S1, as well as the second tier of agency requests for additional funds for salaries. The assumption for the funding needed for this more aggressive implementation of the pay for purpose approach is based on attempting to increase total cash compensation, on average, to 95 percent of the market median. Assuming the seven percent increase necessary to achieve 95 percent of the median, it would cost roughly $231 million.

This $231 million would be applied to the agency requests for increased salaries that are designated as first and second tier through the pay for purpose approach. Allocating the funds in this way would improve the State's ability to recruit, retain, and motivate employees in the appropriate agencies, job roles, and geographic locations where improvement is needed. This level of targeted salary increases would raise benefit costs by an additional $53 million, resulting in a total estimated annual cost in the first year of this option's implementation of $284 million (Table 12).

Table 12: Summary Assessment of Potential Impact of Option S2

	Purpose			Cost	
	Recruit	*Retain*	*Motivation & Morale*	*Projected Cost*	*Future $ Risk Level*
Aggressive Pay for Purpose (S2)	↑	↑	↔	$284 million	Higher

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful

Source: JLARC staff assessment, 2008.

Chapter 4

Health Insurance Benefits

In Summary

Health insurance is among the State's most effective recruitment and retention tools, in part because of its high value relative to other employer health plans. However, health benefits only partially achieve the purpose of promoting health and productivity because costs limit access for some lower income employees and a lack of data about employee health hinders the State's ability to tailor wellness and disease management programs to employee health needs. Health insurance costs have doubled in seven years, growing faster than salaries, total compensation spending, and the ten largest agency appropriations. A variety of factors, including plan design, cost-sharing, the degree to which services are consumed efficiently, and the health of the workforce contribute to the program's cost. Mercer projects that if changes are not made to address these factors, State costs could continue to increase by ten percent a year, reaching $1.1 billion in five years. Based on this projection, JLARC staff and Mercer identified two options for consideration that would result in moderate and more aggressive reductions in the projected growth of health insurance costs for the State. Some of the cost avoidance, particularly for the more aggressive option, may be realized by shifting more financial responsibility to employees.

The study mandate directed JLARC staff to review the adequacy of benefits for State employees, as well as address the long-term growth of benefit costs. This chapter assesses the adequacy of the State's health insurance benefits against the purposes of recruitment, retention, and employee health and productivity. The chapter also discusses the cost pressures confronting the State health insurance plan and identifies potential options to change the State's approach to health insurance benefits.

HEALTH INSURANCE IS STATE'S MOST EFFECTIVE RECRUITING AND RETENTION TOOL, BUT COULD BETTER ENCOURAGE EMPLOYEE HEALTH

As noted in Chapter 1, the State provides employees the opportunity to participate in one of three health insurance plans. In 2007, these health plans had 190,025 members. Roughly 44 percent (82,825) of these were State employees, while the remaining members were either spouses and children of employees, or retirees (and their dependents) who have remained in the health insurance plan after retirement.

Health Insurance Benefits Are State's Strongest Compensation-Related Recruiting and Retention Tool

On the JLARC staff survey of State agencies, 86 percent of agencies agreed the State's health insurance plans are an effective recruiting tool for prospective employees who are single and/or have no children, and 96 percent of agencies agreed the health insurance plans effectively recruit prospective employees who have families. Moreover, 80 percent agreed that health benefits are an incentive for employees to stay with their agency.

Employees confirmed agencies' assertions about how effective health insurance benefits are at recruitment and retention. After the stability and security of State service, health insurance benefits were the most frequently cited reason why employees chose to work for the State. While the State's health insurance benefits were highly attractive to all types of employees, those making lower salaries and those covering their spouses or families were more likely to agree that health insurance played a role in their decision to work for the State.

State's Health Insurance Benefits Compare Favorably to Those of Other Large Employers

The effectiveness of the State's health insurance benefits as a recruiting and retention tool depends in part on their relative value compared to what is offered by other employers. Overall, the value of the State's health insurance benefits is similar to other large organizations and governments. Mercer compared Virginia's health insurance benefits to the 16 large peer employers noted in Chapter 2 and also to seven nearby states. Mercer calculated a dollar value for Virginia's benefit and the benefits provided by the other employers, and found that Virginia's medical and dental benefits ranked fourth and third among the 16 large peer employers, and second and first compared to the seven other states.

Seven Nearby States Selected For Comparison

Mercer compared the value of Virginia's benefits to Maryland, West Virginia, Kentucky, Tennessee, North Carolina, South Carolina, and Georgia. The comparison used Mercer's standardized methodology that assigns a benefit value based on the after-tax income an employee would need to purchase the benefits in the external market. More information about this comparison is provided in Appendix C.

Virginia pays a greater portion of the total premium on behalf of its employees, and its plan features similar out-of-pocket costs when compared to other employers. Mercer found that six other states require employees to pay a median contribution of 17 percent for single coverage and 24 to 31 percent for family coverage (one state bases contributions on pay). In contrast, Virginia requires its employees to pay 10 percent of the single premium and 12 percent of the family coverage premium.

A broader assessment confirms Mercer's results. As shown in Table 13, Virginia pays a higher percentage of premiums on behalf of employees than other state and local governments and private sector employers, particularly for family coverage. Based on the

Table 13: Virginia Pays More of Premiums for Family Coverage Than Other Governments and Private Employers

Employer	% of Total Premium Paid by Employer	
	Single Coverage	*Family Coverage*
Virginia	90%	88%
State and local governments	90	74
Private employers (100+ workers)	82	74

Source: Bureau of Labor Statistics 2007 National Compensation Surveys for Private Industry and State and Local Government Workers.

Bureau of Labor Statistics National Compensation Survey in 2007,Virginia paid eight percent more of the premium for employees with single coverage and 14 percent more of the premium for those with family coverage than other private employers.

In terms of out-of-pocket costs (such as copayments, deductibles, and coinsurance), Mercer found that Virginia's COVA Care plan was similar to the nearby states, but slightly below the median of the 16 large peer employers. When compared more broadly to large employers with similar health plans, as described in the Kaiser Family Foundation/HRET 2007 Annual Employer Health Benefits Survey, Virginia's COVA Care annual deductibles were lower than average. Its copayments were also relatively low for brand name drugs but high for generic drugs and office visits compared to other employers with similar plans.

Employee Cost and Health Management Programs Only Partially Encourage Employee Health and Productivity

The State also provides health insurance benefits to facilitate productivity by helping employees access the care they need to stay well, reducing absenteeism due to illness, targeting specific health problems to improve overall health, and promoting healthy lifestyles. Although 80 to 96 percent of agencies found health benefits to be effective in recruiting and retaining employees, only 58 percent of agencies agreed that the State's health-care approach encourages their workforce to be healthy and productive. Several variables appear to contribute to the partial effectiveness of the health benefits in promoting health and productivity, including concerns of lower income employees about the affordability of premiums and out-of-pocket costs, and the limited role wellness and disease management programs play in encouraging employee health.

Lower Income Employees Express Concern About Premiums and Out-of-Pocket Costs. Overall, employees are able to participate in the plan, but lower income employees in particular expressed concern about premium costs. According to DHRM, approximately 91 percent of eligible employees are enrolled in a State health plan. Further, less than one percent of employees responding to JLARC's employee survey indicated they were not enrolled because they could not afford the premiums. While premium costs do not appear to deter employees from enrolling, 13 percent of enrolled employees disagreed that they can afford premium costs based on their income and expenses. Lower income employees were most likely to disagree, with 25 percent of employees making $25,000 or less per year disagreeing. Employees with single coverage were most likely to agree they can afford their premiums (67 percent), while employees with either a child or children, but no spouse, covered by their plan were least likely to agree they can afford their premiums (55 and 46 percent, respectively).

While cost-sharing provisions are intended in part to raise employee awareness about the cost of services and encourage employees to consume health services responsibly, they can also counteract the State's purpose of having a healthy workforce if individuals are not accessing needed care because of out-of-pocket costs. If employees go without necessary care, this could result in poor health outcomes and higher long-term costs for both employees and the State. The State has taken several steps in recent years to ensure that employees can access the care they need, such as providing free preventive care. Nevertheless, 15 percent of employees reported they had to go without care or medication in the past year because of out-of-pocket costs. Here again, employees with lower incomes were much more likely to go without care, with 27 percent of employees making $25,000 or less reporting they went without a service or medication.

Wellness and Disease Management Programs Are Not a Major Factor in Employee Health. The State has a long history of offering programs to promote employee health and well-being. For instance, the State's wellness program, CommonHealth, is now in its 22nd year of operation. State employees also have access to employee assistance programs, a 24-hour nurse line, smoking cessation programs, a prenatal program (Future Moms), a disease management program (ConditionCare), and partial reimbursement for participation in Weight Watchers.

Despite the various wellness and disease management programs that are available, only 42 percent of employees agreed that these programs encourage them to maintain and/or improve their health. Fifteen percent of employees disagreed that these programs promote health and 43 percent had no opinion. The primary reasons why employees disagreed were because they did not feel they needed these programs to stay healthy (40 percent), or they preferred to handle their disease management with their personal physicians (37 percent). However, roughly one-quarter of employees did not feel there were good incentives or rewards for healthy behavior, or were not interested in the types of programs that were offered. One fifth were not aware that these programs were available.

These survey results suggest that the State is missing opportunities to more comprehensively address employee health. In particular, there may be opportunities to better promote the available programs and provide incentives to encourage participation. However, DHRM began managing CommonHealth without an outside vendor in July 2008, and since then has made several changes to improve employee awareness and access to program offerings, including enhancing the employee website. As a result, DHRM staff report substantial increases in participation in CommonHealth (66 percent increase from last year's quarterly average) and the smoking cessation program (12 times as many employees have signed up for the program).

Incentives to Participate in Health Management Programs

In 2007, Missouri won an award for their wellness initiatives. Participants who complete a health risk assessment (HRA) and other program requirements, such as receiving calls from a health coach, receive a discount on their health insurance premiums. Last year, over 40 percent of employees completed the HRA, and over 80 percent of those employees enrolled in the program.

To date, however, the State offers few meaningful incentives for employees to participate in the various programs. Most of the incentives that are offered are token rewards, such as water bottles and umbrellas. However, DHRM has made a recent improvement in this area as well. Beginning in FY 2009, COVA Care waives the $300 inpatient hospital copayment for delivery for expectant mothers who complete the Future Moms prenatal program. DHRM staff indicate that they are considering offering incentives for other wellness programs as well.

EMPLOYEE HEALTH INSURANCE COSTS ARE INCREASING AS PORTION OF STATE SPENDING

The competitive health insurance benefits the State provides to its employees come at a cost. In FY 2007, the total program expense for employee health benefits (a portion of which was funded by employee premiums) was $759 million, an amount roughly equal to Virginia Commonwealth University's operating budget. In fact, if the State's health insurance program had been considered a single agency in 2007, it would have ranked as the 11th largest agency in terms of appropriations (Table 14). Furthermore, between FY 1998 and FY 2007, employee health insurance spending grew at a faster rate than total State appropriations and appropriations for each of the ten largest agencies, including the Department of Medical Assistance Services, the budget of which is driven primarily by Medicaid funding. Moreover, health insurance spending grew from 10.8 to 13.5 percent of the State's total compensation spending between FY 2003 and FY 2007.

Table 14: State Health Insurance Is a Substantial and Growing Portion of State Spending

State Agency	Appropriations ($ in Millions) FY 1998	FY 2007	% Growth
Total Appropriations	*$17,621.0*	*$35,095.0*	*99.2%*
Department of Education	3,413.6	6,566.9	92.4
Department of Medical Assistance Services	2,396.7	5,320.5	122.0
Virginia Department of Transportation	2,048.3	4,183.5	104.2
University of Virginia (Including Medical Center)	872.9	1,904.5	118.2
Department of Social Services	958.2	1,739.0	81.5
Department of Corrections	586.6	957.0	63.1
Virginia Tech	460.5	874.4	89.9
Department of Mental Health, Mental Retardation and Substance Abuse Services	569.9	870.2	52.7
Virginia Community College System	391.1	859.4	119.7
Virginia Commonwealth University	414.5	780.1	88.2
State Health Insurance Program Expense [a]	**322.8**	**759.0**	**135.1**

[a] Total program expense includes claims and administrative costs and is funded by State and employee premiums.

Source: 1998 and 2007 Appropriation Acts and DHRM's FY 1999 and 2007 Health Benefits Program Annual Reports.

The cost pressures confronting the State are not unique, but rather are being experienced by employers and health plans nationwide. As Virginia's total program expense doubled from 2000 to 2007 (from $378 to $759 million), the cost of providing health benefits nationwide also doubled, though workers' wages and inflation increased only 25 and 21 percent, respectively. Further, while Virginia's health insurance costs have consumed a growing portion of the State's budget, national health expenditures have also increased as a portion of the entire gross domestic product, from 13.7 in 1993 to 16.3 percent in 2007.

State Provides Premium Relief in FY 2009

In FY 2009, the State is providing employees and agencies with a credit to temporarily offset health insurance premium increases. The Employee Premium Increase Credit (EPIC) ranges from $3 to $9 a month for employee only and family coverage. Agency credits range from $33 to $104 a month. These credits are made possible by a surplus which has accumulated in the Health Insurance Fund.

The majority of State employees agreed their premium costs were fair and reasonable, though 16 percent disagreed. Cost, in particular the fact that health insurance premiums have increased faster than salaries, was cited as employees' primary concern. From 2003 to 2007, employee premiums increased roughly three times faster than State salaries. However, the rate of growth has slowed in recent years and, in FY 2009, DHRM is providing employees with a credit which actually decreases their premiums.

Substantial rates of growth have been driven by many factors, some of which are outside the State's control, such as increased labor costs and more expensive health-care technologies. Some factors driving the growth, however, are at least partially within the State's control, including overall plan design and cost sharing between the State and employees, the degree to which health services are consumed efficiently, and the health of the workforce.

Current Plan Design and Cost Sharing Drive State Cost Increases

Premium contributions are the primary determinant of the portion of overall plan costs that are paid by the State. Currently, the State pays roughly 88 percent of premium costs for employees and family members (Table 15), and roughly 75 percent of total costs (including employee out-of-pocket costs). Although the portion of premiums paid by the State is slightly higher for employee-only coverage, the actual amount paid by the State is substantially higher for family coverage. In fact, in FY 2009, the State pays $8,004 more for an employee with family coverage under the basic plan than for an employee with single coverage.

Mercer highlighted a consequence of heavily subsidizing health insurance for family members, characterizing the State as the "insurer of choice" for employees with families. While 91 percent of State employees are enrolled in a State health plan, other large employers typically enroll closer to 80 percent of their employees. Low employee premiums in the State plan likely encourage either (1) employees who could obtain coverage through a spouse to participate in the State plan or (2) employees to insure their spouses who could be covered under the spouse's employer plan. In FY 2007, spouses comprised 22 percent of total membership and accounted for $140.2 million, or 29 percent, of plan expense. According to the JLARC staff survey of State employees, roughly half of spouses in a State health plan were eligible to be covered under their own employer's plan, but were insured under the State plan instead.

While the State has maintained a relatively constant level of cost-sharing with employees over the past five years, when COVA Care was introduced in FY 2004, employee contributions for standard family coverage dropped for a large portion of employees from about 30 percent to just more than 12 percent of total premium costs. At the same time, employee-only premiums increased from

Table 15: State Pays About 88 Percent of Monthly Premiums for Basic COVA Care

Type of Coverage	Employee Share	State Share	Portion Paid by State
Employee Only	$44	$411	90.3%
Employee Plus One	107	735	87.3
Family (Employee plus two or more family members)	153	1,078	87.6

Notes: Rates reflect true premiums and do not account for credits given to employees and agencies in FY 2009 to temporarily offset premium increases. The employee credit offsets rates by $3 to $9 a month and the employer credit offsets rates by $38 to $104 a month.

Source: DHRM summary of available plans and monthly premiums effective July 1, 2008.

about seven to just under ten percent. DHRM staff indicated that family premiums were decreased to shield employees who had been enrolled in the State's no premium plan (Cost Alliance) prior to COVA Care from substantial cost increases. DHRM also noted, however, that it expected the employee share of family coverage to be gradually increased in subsequent years. Because this change never occurred, the State is now subsidizing a larger portion of family coverage than in the past.

More fundamentally, State cost increases have also been driven by the fixed cost provisions of the plan, which have been modified very little in recent years. Employees contribute toward the cost of their care through out-of-pocket costs, such as annual deductibles, coinsurance, and copayments. The majority of services covered by COVA Care require employees to pay a fixed dollar amount, or copayment, at the time of service. Typically, the copayment represents only a portion of total costs, and sometimes the actual cost to the plan is significantly higher than the copayment amount. Because copayment costs are fixed, any cost increases for care or medication are borne by the State. Without frequent adjustments, the share of costs paid by employees diminishes over time. Since COVA Care was introduced, there has been only one increase in employee out-of-pocket costs, which occurred in FY 2009 when a dental deductible was introduced. By contrast, coinsurance, which requires employees to pay a portion of the actual cost of service, ensures that both the State and employees absorb cost increases; but this provision is required for only a small number of services.

Because copayment costs are fixed, any cost increases for care or medication are borne by the State.

Limited Emphasis on Efficiency Contributes to Higher Plan Costs

One way to encourage efficient use of services, thereby reducing total plan costs, is setting copayments to reward employees for using the most cost-effective service or medication available. For instance, Virginia provides a three-tier drug plan which requires employees to pay a higher cost for brand name drugs than for generic drugs. The purpose of this structure is to encourage the use of less expensive but equally effective medications. Employees who prefer more expensive brands have to pay more. Similarly, the copayment is higher for a visit to a specialist than a primary care physician in part to encourage consumers to obtain services through a primary care physician when possible. In each of these cases, the greater the differences between copayments, the more likely employees are to choose the less expensive option.

However, according to Mercer, the State's current cost sharing approach could better encourage employees to make more cost efficient choices. For example, under COVA Care, the copayment for a primary care physician visit is $25, while the copayment for a spe-

Brand Name Drugs and Specialists Cost Significantly More

According to Mercer, the amount a health plan typically pays for a brand name drug is four times higher than the cost of a generic drug. Similarly, a health-care specialist visit typically costs twice as much as a visit to a primary care physician.

cialist visit is $35. It is likely that this $10 difference may be insufficient to encourage employees to first seek treatment (when appropriate) from lower cost primary care physicians. Similarly, the copayment for generic drugs at a retail pharmacy is $15, while the copayment for low to medium cost brand name drugs is $20 (for a 34-day supply). This $5 difference may not be sufficient to encourage employees to choose the less expensive generic drug. Although the State already encourages the use of generic drugs through a mandatory generic program (which requires employees to purchase a generic drug when available or pay the cost difference), greater differentiation in copayments could further promote the use of generic alternatives to brand name drugs in the same therapeutic class.

Cost-sharing provisions can also be designed to encourage employees to seek preventive care or comply with their disease management regimen. Within the past few years, the State has waived copayments and coinsurance for preventive services to encourage employees to get routine check-ups and exams to help identify problems before they develop into potentially more serious conditions and lead to higher costs. Mercer noted that similar opportunities likely exist for the State to reward employees who participate in a disease management program by waiving copayments for their maintenance medications. Research indicates that compliance with medication for certain chronic conditions, such as diabetes and asthma, reduces costs over the long run.

More broadly speaking, health insurance plans and cost-sharing provisions can be designed to encourage employees to be informed and efficient consumers of health care. Coinsurance, which requires employees to pay a percentage of the cost of a health-care service or medication, is one method that can increase consumer awareness about the actual cost of services. In theory, consumers who are aware of costs are more likely to view health care as a commodity and therefore limit or manage their use of services. However, as noted above, most services covered by COVA Care require a copayment rather than coinsurance.

In FY 2007, the State began offering employees the COVA High Deductible Health Plan (HDHP), which utilizes coinsurance for all services (other than preventive care). The HDHP has higher yearly deductibles than the basic COVA Care plan ($1,200 for single coverage or $2,400 for family coverage) and participants may establish health savings accounts (HSAs), which allow individuals to make tax-deductible contributions to pay for certain medical expenses. The theory behind this type of plan is that employees in the plan will consume health care more carefully because unused portions of their HSA account can roll over for future medical costs. This plan is less expensive for the State when compared to

Characteristics of COVA HDHP Participants

According to the JLARC staff survey of classified employees, there does not appear to be a relationship between participation in COVA HDHP and age, education level, salary, or coverage level. However, employees in this plan were less likely to agree that they can afford their out-of-pocket costs, less satisfied overall with their plan, and less likely to agree that their health benefits play a significant role in their decisions to continue working for the State.

the COVA Care plan because it shifts more financial risk to the employee. For instance, the State spends $552 less per year for an employee with COVA HDHP single coverage, and $1,080 less per year for employees with family coverage.

Despite the lack of employee premiums for this plan, less than one percent of covered employees are enrolled in COVA HDHP. In the JLARC staff survey of employees, the most frequently cited reason employees gave for not enrolling is they feel safer with a traditional health plan and would feel vulnerable to high medical bills (48 percent). Employees also reported they could not afford the high deductible (36 percent), the plan did not make sense given their out-of-pocket expenses (29 percent), and they were not aware of or did not understand the plan (23 percent). In addition, because COVA Care premiums are heavily subsidized by the State and the plan has much lower out-of-pocket expense limits than COVA HDHP ($1,500 versus $5,000 for one person, and $3,000 versus $10,000 for more than one person), most employees do not have a financial incentive to enroll in COVA HDHP.

Lack of Comprehensive Health Data Hinders State's Ability to Improve Health and Control Costs

As described earlier, the State has a long history of providing wellness benefits to employees; however, most of the programs offered to employees are not designed to address the specific needs of any segment of the workforce. A lack of comprehensive data about employees' lifestyles keeps the State from devising beneficial and cost-effective programs to address existing health problems.

Although the exact impact of employee and family members' lifestyles on health-care costs in Virginia is hard to estimate, opportunities for improving health clearly exist. In 2007, about 25 percent of adults in Virginia were obese and 19 percent of adults smoked, according to the Centers for Disease Control and Prevention (CDC). Assuming obesity and smoking occur at a similar rate among adult members of COVA Care as they do in the general population, over 37,000 members may be obese and over 27,000 may smoke. Obesity and smoking contribute to some of the State's most expensive chronic and manageable conditions, such as diabetes, hypertension, chronic respiratory disease, and coronary artery disease. Based on CDC statistics and COVA Care data for 2006, Anthem estimates that over eleven percent of COVA Care medical claims costs could be attributed to obesity. Mercer notes that in some cases lifestyle choices can be responsible for as much as half of a plan's total costs.

Part of the difficulty in determining the impact of members' health on claims costs is the lack of comprehensive data about their life-

DHRM Considering Proposals for Improved Health Data

The State has four vendors for medical, prescription drug, dental, and mental health benefits. To date, data coordination has occurred for certain purposes, such as identification of employees for the disease management program. However, during the current procurement for health plan services, DHRM is requiring enhanced data integration services which could increase the future availability of health data.

styles and risk factors. One tool that employers use to measure the risk and impact of members' lifestyles on plan costs is a Health Risk Assessment (HRA). These questionnaires, in combination with biometric screenings, offer employees an opportunity for early identification of problems and also provide data that can be used to identify employees who could benefit from various health and disease management programs. According to Mercer, 78 percent of "jumbo" employers (those with 20,000 or more employees) utilize health risk assessments.

While offered in Virginia, only eight percent of enrolled employees and retirees completed an HRA in FY 2007, in part because of a lack of meaningful incentives. This low completion rate of the HRA has prevented the State from identifying employees who could benefit from improved health and designing programs tailored to their needs. Employers that collect this information in a comprehensive way use it to stratify employees based on their lifestyle risk factors and design targeted programs to address their health needs. According to Mercer, among the 80 percent of large employers that utilize health management strategies, 63 percent believe they have been at least somewhat successful in controlling health benefit costs or improving workforce health and productivity. Furthermore, studies commonly cite a return on investment between 150 and 300 percent for wellness programs after three to five years.

OPTIONS TO CONTROL THE GROWTH OF STATE COSTS THROUGH IMPROVED EFFICIENCY, HEALTH MANAGEMENT, AND INCREASED EMPLOYEE COST-SHARING

As shown in Table 16, the State's approach to health insurance is achieving its purposes of recruiting and retaining employees, and partially achieving its purpose of encouraging employee health and productivity. The greatest concern with the health insurance program is its historical and projected rate of growth. In fact, Mercer projects that COVA Care's plan design, if not actively managed, will result in the State's share of costs reaching $1.12 billion in five years, an increase of over $400 million. As described earlier, the health insurance program has been growing at a faster rate than total appropriations and other elements of compensation, in part because of factors which are largely outside the State's direct control. Accordingly, JLARC staff classified the relative future financial risk of this program as "high" relative to the other elements of compensation.

Although not all of the factors which drive program spending are within the State's direct control, adjustments to the health insurance plans appear to be needed to reduce the level of long-term fi-

Table 16: Summary Assessment of Current Approach to Health Insurance Benefits

	Purposes			Cost	
	Recruit	*Retain*	*Health & Productivity*	*Current $*	*Future $ Risk Level*
Health Insurance	●	●	◐	$759 million[a]	High

Legend for Scale of Purpose Achieved | ● Mostly | ◐ Partially | ○ Minimally

[a] Total program expense includes claims and administrative costs and is funded by State and employee premiums.

Source: JLARC staff assessment, 2008.

nancial risk associated with providing this benefit. As noted earlier, employers nationwide are grappling with how to manage the growth of health insurance costs. According to Mercer's National Survey of Employer-Sponsored Health Plans in 2007, the majority of employers planned to shift a greater portion of costs to employees in 2008 through changes to contributions or out-of-pocket costs. Mercer's survey also found that large employers are using other strategies to slow cost increases, such as health management programs (80 percent of large employers in 2007).

It is paramount that both the State and its employees take steps to control health insurance costs.

Given that health insurance costs are likely to continue increasing at a faster rate than projected State revenues, total compensation spending, and employee salaries, it is paramount that both the State and its employees take steps to control health insurance costs. This may be especially important for the State given the aging of its workforce. In FY 2007, the average cost for plan members age 50 or older was twice that of members age 30 to 39. As the State workforce continues to age, a greater portion of the State's plan membership will be older—and more expensive. This reality places even greater importance on ensuring the health insurance benefits the State provides achieve the purposes of recruitment, retention, and employee health and productivity—but in a way that is fiscally sustainable over the long term.

JLARC staff and Mercer have developed two options for managing the future growth of the State's health insurance costs, while also focusing on employee health and productivity. Both of the options require the State to actively manage the health plans on a continuous and ongoing basis through various changes to plan design and efficiency, premium contributions, employee choice, and health management. The parameters of options H1 and H2 are designed to illustrate the varying degrees of changes that would have to be made over time to moderately or more aggressively manage the growth of future plan costs for the State. Particularly under the more aggressive option, some of the State's cost avoidance would

Health Insurance Guiding Principles

Controlling health insurance costs requires, at times, making decisions that balance access, affordability, and health with taxpayer costs. A set of guiding health insurance principles can be helpful when making these difficult decisions. Principles can address target membership and access levels, affordability for low income employees, and prioritization of scarce resources towards employees.

be achieved by shifting more of the financial responsibility to employees. Under either option, changes should be made consistent with guiding principles to minimize negative health outcomes.

Option H1: Moderate Changes to Health Insurance Benefit to Reduce Growth of State Spending

Mercer and JLARC staff identified a series of potential changes that could be made over time to reduce the projected rate of growth for State health insurance costs. Examples of changes in plan design and efficiency, premium contributions, employee choice, and health management that could be implemented to achieve this more moderate growth in plan costs are summarized in Table 17 and described in more detail below.

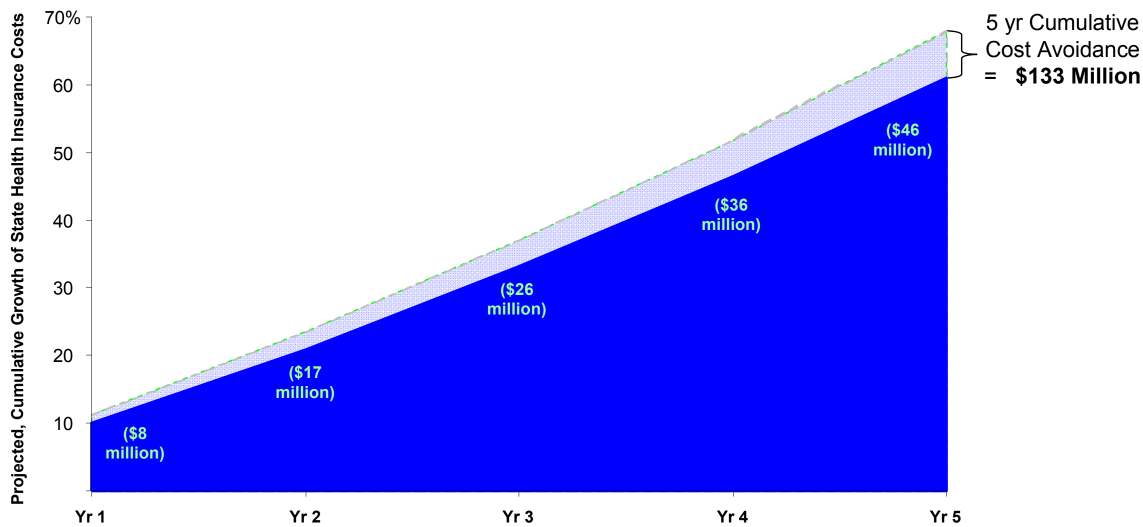
When compared to Mercer's baseline projections of State costs reaching $1.12 billion by 2012, Mercer estimates that changes such as those described below could achieve cumulative cost avoidance of approximately $133 million over a five-year period (Figure 12). This would be achieved by cost avoidance of approximately $8 million in the first year of implementation, with progressively larger cost avoidances each year, and $46 million in cost avoidance in the fifth year of implementation. It should be noted that the estimate of cost avoidances is illustrative, and actual amounts will depend on the specific combination of changes implemented. DHRM's health insurance actuary should prepare a revised estimate based on the specific changes considered by the General Assembly.

Table 17: Option H1—Examples of Moderate Changes to Health Insurance Benefit

Category	Option
Plan Design / Efficiency	Create more differentiation between copayments for generic and brand-name drugs.
	Create more differentiation between copayments for specialists and primary care physicians
	Reduce copayments for maintenance medications for employees who participate in disease management programs.
	Increase coinsurance on high cost procedures such as MRI, CT Scan, and PET Scan
	Index fixed dollar provisions of plan (deductibles and copayments) to some extent to cost trends. Some changes should occur annually.
Premium Contributions	Set target cost share at current level and maintain.
	Change three tier coverage design to four tiers (employee only, plus one, plus children, and plus family) and implement spousal surcharge.
	Within target cost-share, charge the employee a lower rate for single coverage and a higher rate for family coverage.
	Adjust early retiree costs or alter plan design to slightly lower benefits for this group.
Employee Choice	Provide cash payment for employees who opt out of participation in health plan if they demonstrate they have coverage elsewhere.
Health Management	Provide incentives for employees to complete a health risk assessment annually and provide information to disease management vendor for review and outreach to individuals with risk factors.

Source: JLARC staff and Mercer assessments of health insurance benefits and costs.

Figure 12: Moderate Changes Could Lead to State Cost Avoidance of $133 Million Over Five Years



Note: Baseline projection assumes a "continuation of recent practice of no material changes in plan design or employee contributions," resulting in a ten percent and one percent annual growth in State and employee costs, respectively. Projections are based on total plan membership and the State's share of total program costs for FY 2007 ($668 million, or 88 percent of $759 million).

Source: JLARC staff analysis of Mercer cost projections, 2008.

Plan Design and Efficiency. The State could implement a series of plan design changes aimed at encouraging employees to make more cost efficient choices. Broadly speaking, these changes would be designed to affect patterns of utilization through incentives, such as lower copayments for generic and maintenance medications. For example, in 2007 prescription drug costs constituted more than 20 percent of total COVA Care claims costs and, according to Mercer, the average allowed amount for a brand name drug was more than four times that of a generic drug. Consequently, changes in drug utilization could render savings for the State. Similarly, Mercer noted that the allowed amount for a visit to a specialist was approximately twice that of a primary care physician in 2007 (excluding lab costs), which also suggests that a change in utilization could result in cost savings. In order to mitigate the impact of increasing the copayment for specialist visits, the State could assign a lower copayment to therapy visits (treatment and rehabilitation of physical and speech problems, typically following a diagnosis), which currently require a specialist copayment. Finally, periodic adjustments to the fixed cost provisions of the plan (deductible and copayments) or increasing the coinsurance for high cost procedures are options that could minimize the impact of future cost increases on the State.

Premium Contributions. Several changes could also be made to premium contributions to prioritize State spending on employees and more proportionately distribute costs based on who is covered under the plan. For example, the State could adjust the portion of costs paid by families to 15 percent instead of 12 percent while still offering a competitive benefit. At the same time, the State could continue to heavily subsidize employee-only coverage to ensure continued access to the plan by employees. Several other states, including North Carolina and Kentucky, take a similar approach by providing employee-only coverage for free or at a low contribution rate while having employees pay a higher percentage of the cost of covering dependents. This is similar to the approach the State took in the early 1990s when employees paid nothing for employee-only coverage but more than 30 percent for family coverage.

Moving from three to four or more coverage levels would allow premium costs to more accurately reflect who is covered by the plan. Currently, the State offers employee-only, employee plus one, and family coverage levels and rates. The problem with this approach is that an employee with plus one or family coverage pays the same rate regardless of whether a spouse is covered, despite the fact that the yearly medical expense per spouse is three times that of a child. Several other states, including North Carolina and South Carolina, offer four or more coverage levels.

Another approach that employers use to manage their costs without directly affecting premium costs for employees is by issuing a spousal surcharge for spouses with other available coverage. According to Mercer, this monthly surcharge typically ranges from \$50 to \$100 in addition to monthly premiums. Although a relatively small number of employers are using a surcharge, Mercer has characterized this as a trend. In 2007, Mercer found that 11 percent of "jumbo" employers (20,000 or more employees) used a surcharge. To date, only one other state appears to require a spousal surcharge. According to benefits staff in Georgia, a \$30 surcharge was introduced to shift the cost of spousal coverage to employees, but they believe they have seen some spouses move off their plan as a result. Mercer staff indicated that employers often see ten to 20 percent of spouses drop off of a plan as the result of a surcharge. Assuming Virginia required a \$50 surcharge and 10 percent of spouses dropped their coverage as a result, the State could save between \$17 and \$22 million a year (depending if ten percent of spouses who are eligible for other employer-sponsored insurance, or ten percent of all spouses, drop off the plan).

As with spouses, the premium rates for early retirees do not reflect their actual cost to the plan. In fact, DHRM staff indicate that retiree premiums would be 75 percent higher if they were not subsidized by active employees. To more proportionately distribute premium rates based on actual claims experience, the State could consider increasing the cost for early retirees by five or ten percent. Alternatively, the State could offer a separate plan with reduced benefits, or restrict enrollment of early retirees to the lowest cost plan offered to active employees.

Employee Choice. As indicated earlier, the State is likely insuring employees who could qualify for coverage through a spouse. In order to encourage them to enroll in their spouse's plan, the State could offer them a cash payment for opting out of the State's plan. This could reduce the overall health plan cost and create an opportunity for employees to receive additional cash.

Health Management. As discussed above, a health risk assessment (HRA) is a useful tool for the State and health plan members. HRAs provide members an opportunity to identify health concerns early, and the State can use the data to encourage members to participate in health and disease management programs and to better design and tailor programs to meet their needs. The State could offer meaningful incentives for employees to complete an HRA. According to Mercer, 40 percent of "jumbo" employers use incentives to encourage completion of an HRA. Although cash and token rewards continue to be the most utilized incentives for participation in health management programs, over a quarter of large employers are now offering lower premium contributions as an incentive.

According to Mercer, the State could make the above changes while still providing "a highly competitive benefit."

According to Mercer, the State could make the above changes while still providing "a highly competitive benefit" which also offers employees a "basis for understanding their impact on healthcare costs, and possibly motivating them to act." Consequently, these changes would minimally impact the effectiveness of the plan as a recruitment and retention tool (Table 18). The impact of these options on employee health will depend in large part on the

Table 18: Summary Assessment of Potential Impact of Option H1

	Purposes			Cost	
	Recruit	*Retain*	*Health & Productivity*	*Projected Annual Cost Avoidance in Year 5*	*Future $ Risk Level*
Moderate Changes to Reduce Growth of State Spending (H1)	↔	↔	↔	$46 million	Lower

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful

Source: JLARC staff and Mercer assessment of health insurance benefits and costs.

exact nature of changes made. However, a heavier emphasis on employee health and disease management would likely offset any reduction in access due to increased out-of-pocket costs, resulting in a minimal or beneficial impact on employee health and productivity. These changes would result in more moderate growth in State health insurance costs over time when compared to the baseline projection, lowering the level of future cost risk associated with the plan. However, the plan would still represent a high level of future financial risk for the State.

Option H2: More Aggressive Changes to Health Insurance Benefit to Further Reduce Growth of State Spending

Mercer and JLARC staff also identified a series of potential changes that could be made over time to further reduce the projected rate of growth for State health insurance costs. When compared to Mercer's baseline projections, Mercer estimates that changes such as those summarized in Table 19 and described below could achieve cumulative cost avoidance for the State as an employer of approximately $316 million over a five-year period (Figure 13). This would be achieved by cost avoidance of approximately $17 million in the first year of implementation, with pro-

Table 19: Option H2—Examples of More Aggressive Changes to Health Insurance Benefit

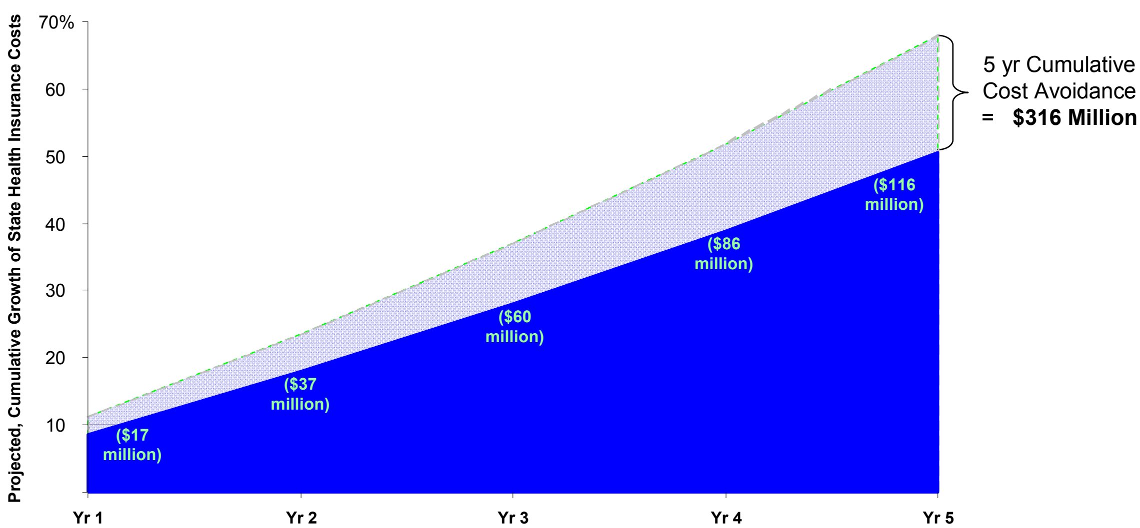
Category	Option
Plan Design/ Efficiency	Implement coinsurance design for pharmacy benefits with a minimum and maximum employee cost share.
	Implement coinsurance for all physician services.
	Increase coinsurance on high-cost procedures and implement a pre-certification program for these procedures.
	Implement a third plan with a higher deductible, coinsurance, and a higher out-of-pocket limit. Set contributions for the COVA Care plan to make the new plan financially attractive for employees.
Premium Contributions	Set lower target for State cost-share and move to that ratio over next five years using increased contributions and plan design changes.
	Implement salary-based contribution approach in which employees who are paid more have higher contribution requirements.
	Set a policy that State will not cover spouses with coverage through their employer.
	Have pre-65 retirees pay their actual claims costs by adjusting their premiums to reflect their claims experience.
Employee Choice	Provide a defined benefit allowance for employees to purchase a standard medical package. Employees who choose options which exceed the allowance must pay the difference and employees who choose a less expensive benefit may receive the difference as a contribution to flexible spending account or health reimbursement account.
Health Management	Require completion of a health risk assessment for enrollment in health benefits and provide information to disease management vendor for review and outreach to individuals with risk factors.

Source: JLARC staff and Mercer assessments of health insurance benefits and costs.

gressively larger cost avoidances each year, and $116 million in cost avoidance in the fifth year of implementation. This cost avoidance would be realized in part by shifting more financial responsibility to employees. The estimate of State cost avoidance is illustrative, and actual amounts will depend on the specific combination of changes implemented. DHRM's health insurance actuary should prepare a revised estimate based on the specific changes considered by the General Assembly.

Plan Design and Efficiency. As with option H1 discussed above, the State could implement a series of plan design changes to encourage employees to make more efficient choices, but under this option more aggressive changes could lead to further management of State cost growth. For example, instead of creating greater differentiation between copayments for medications and services, the State could implement a coinsurance design for pharmacy and physician services. Because coinsurance requires consumers to pay a percentage of the actual cost of services, this approach naturally provides an incentive for employees to seek less expensive services and medications. It also prevents the State from absorbing all future increases in the cost of services and medications. To the extent that coinsurance increases employee out-of-pocket spending, this could limit the use of unnecessary health care; but could also restrict some individuals' access to needed care.

Figure 13: More Aggressive Changes Could Lead to State Cost Avoidance of $316 Million Over Five Years



Note: Baseline projection assumes a "continuation of recent practice of no material changes in plan design or employee contributions," resulting in a ten percent and one percent annual growth in State and employee costs, respectively. Projections based on total plan membership and State share of total program costs for FY 2007 (88 percent of $759 million, or $668 million).

Source: JLARC staff analysis of illustrative Mercer cost projections, 2008.

To further encourage efficient use of services, Mercer recommended creating a plan with 80/20 coinsurance, a $500 deductible (for single coverage), and a $2,500 out-of-pocket expense limit. In theory, the higher deductible and coinsurance provisions raise consumer awareness about the costs of health care, thereby encouraging them to seek cost-efficient services. According to Mercer, creating this plan "gives employees the choice to decide which plan is better for them and, if priced correctly, will lower the Commonwealth's overall costs." In order to encourage enrollment in this plan, it could be offered as the standard plan and priced accordingly. For example, employees who choose this plan would pay lower premiums while employees who choose a plan with lower out-of-pocket costs (such as COVA Care) would have to pay higher premiums. However, the State could also provide opportunities for employees enrolled in the more expensive plan (COVA Care) to reduce their costs by financially rewarding healthy behaviors, such as completing a health risk assessment or participating in a disease management or wellness program.

It should be noted that, in exchange for lower employee premiums, a higher deductible health plan shifts more of the financial risk to employees and holds them more accountable for decisions about their health and health care. Accordingly, if the State were to implement this option, it would need to require its vendors to provide adequate information to consumers about the cost and quality of providers. Absent this information, employees could make poor decisions regarding their health.

Premium Contributions. Here again, the changes which could be made are similar to but more aggressive than option H1. For instance, instead of maintaining its current level of cost-sharing with employees, the State could, over a period of time, reduce its contributions to 80 percent and require early retirees to pay a premium which more closely reflects their actual claims costs (and is therefore not as subsidized by the State and active employees). The State could also prohibit spouses who have other coverage available to them from enrolling in a State plan. According to Mercer, six percent of large employers (500 or more employees) and three percent of "jumbo" employers (20,000 or more employees) use this approach.

Finally, the State could implement a salary-based premium strategy in which premium contributions increase as salaries increase. The benefit of this approach is that the State could increase employees' overall share of premium costs without restricting access and negatively impacting the health of lower-income employees. Typically, employers who use this approach stratify employees into a few income tiers with different premium rates. According to Mercer, 25 percent of "jumbo" employers use this approach. In addition, at least five other states use this strategy, including Illinois, Kansas, West Virginia, Rhode Island, and New Mexico. Two other states, Pennsylvania and New Jersey, require employees to pay a percentage of their salaries toward the cost of their coverage.

Several States Provide Benefits Allowance

California, Montana, and Oklahoma offer set allowances to cover the employees' core medical coverage. Employees who choose coverage options which exceed the allowance pay the difference while employees who choose options which cost less than the allowance may be able to keep the additional amount. Benefit staff in Montana indicate that a major strength of this approach is its financial sustainability.

Employee Choice. Some employers offer a benefit allowance, or a set cash or credit amount, for employees to purchase benefits. Typically, the allowance is enough to cover at least the cost of employee only coverage for a standard medical package. Employees who choose to purchase additional benefits or dependent coverage have to pay the difference. Employees who choose a less expensive benefit may be given the option to receive the additional cash in a flexible savings account or health reimbursement account.

While this approach could free up cash for some employees, it is not clear whether employees would be willing to elect a less expensive benefit to receive cash. DHRM staff indicate that State employees tend to be risk averse, which is demonstrated by extremely low enrollment in the State's premium free HDHP. Depending on how the allowance amount is determined, this approach could be designed to offer employees the opportunity to receive cash, or it could be designed to limit the State's share of costs. This option would likely work best if there were greater differentiations in the rates for various plans and coverage levels.

Health Management. Instead of merely providing incentives for completion of a health risk assessment, the State could require completion before employees and family members could enroll in a State health plan. Other changes which enhance the State's health management programs have the potential to further mitigate the cost trend.

In summary, by making more aggressive changes to plan design and contributions, the State would potentially harm the health insurance plan's effectiveness as a recruiting and retention tool (Table 20). Further, continuing to shift financial responsibility to consumers increases the possibility that lower income employees will have less access to needed services and medications. As indicated earlier, 15 percent of employees already report forgoing care because of out-of-pocket costs. However, a stronger emphasis on health management could help offset these negative outcomes through early identification and treatment of employee health problems. Furthermore, these types of more aggressive changes would lower the level of future cost risk associated with the State insurance plan when compared to current baseline projections.

Table 20: Summary Assessment of Potential Impact of Option H2

	Purposes			Cost	
	Recruit	*Retain*	*Health & Productivity*	*Projected Annual Cost Avoidance in Year 5*	*Future $ Risk Level*
Aggressive Changes to Reduce Growth of State Spending (H2)	↓	↓	↔	$116 million	Lower

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful

Source: JLARC staff and Mercer assessment of health insurance benefits and costs.

Chapter 5

Retirement Benefits

In Summary

The defined benefit retirement plans the State provides are competitive with what other employers offer and achieve their goals of retaining longer-tenured employees and providing an adequate benefit to retire. The majority of recent retirees retired prior to the normal retirement ages of 65 for the regular Virginia Retirement System plan and 60 for the State Police Officers Retirement System and Virginia Law Officers Retirement System. These plans, when combined with Social Security, replace between 82 and 92 percent of an average employee's pre-retirement income. However, contributions to the plans have historically been below what were recommended to fully fund the plan's obligations, resulting in a cumulative shortfall in contributions of $526 million for the regular VRS plan alone. To increase the likelihood that the VRS defined benefit plans can be sustained and continue to achieve their purposes, JLARC staff and PricewaterhouseCoopers have identified a series of options designed to reduce the near-term and long-term financial risk level associated with offering the plans. However, these options either require an employee contribution toward the plan costs, a reduction in retirees' cost of living adjustment, an increase in the minimum retirement age, or alternative retirement plan designs.

The study mandate directed JLARC staff to assess the appropriateness of the provisions and requirements of the retirement systems. The State manages three separate retirement plans for classified employees: the Virginia Retirement System (VRS) plan for most State employees; and the enhanced State Police Officers Retirement System (SPORS) and Virginia Law Officers Retirement System (VaLORS) plans for law enforcement employees.

VRS also administers the Judicial Retirement System and plans on behalf of nearly 600 different political subdivisions and local school divisions. In part because of the economies of scale achieved by administering these defined benefit plans with a similar or identical structure, VRS has comparatively low administrative costs. Total administrative costs in FY 2008 for VRS were about $44 per member, which is well below the peer median of $76 per member.

This chapter assesses the effectiveness of the State's retirement benefits against the purposes of recruitment, retention, and allowing State employees to retire at the appropriate time with adequate benefits. The chapter also assesses the level of costs and financial risk associated with the State's retirement plans and identifies a series of options to address the State's costs and level of financial risk. In addition, because of the magnitude of State spending associated with the schoolteachers retirement plan through the Standards of Quality (SOQ) funding formula, and because of the desire to keep VRS administrative costs low, this chapter also addresses the impact of applying these options to the teacher retirement plan.

RETIREMENT BENEFITS RETAIN EXPERIENCED EMPLOYEES, LESS IMPORTANT TO NEWER EMPLOYEES

The primary reason the State offers a retirement plan is so employees can retire at the appropriate time with an income level that maintains a reasonable standard of living. In addition, the defined benefit plan design and its long-term accrual of benefits is intended to retain employees as they progress in their careers. The plans are also intended to help recruit prospective employees.

VRS Benefit Is an Effective Retention Tool for Longer-Tenured Employees but Has Limited Impact on Recruiting

An employer's retirement plan is rarely the primary recruiting tool for prospective employees. In fact, retirement ranked fourth among respondents to the JLARC staff survey of classified State employees as a reason to work for the State, and fewer than half agreed that the benefit played a significant role in their initial decision to work for the State. Retirement benefits are also generally not the main retention factor for employees early in their careers. On the JLARC staff survey of State agencies, fewer than half of agencies agreed that the retirement plan was an incentive for recently-hired employees to remain with the State.

However, consistent with its intent, the State's defined benefit retirement plan design appears to become a more effective retention tool the longer an employee works. Ninety-two percent of agency staff agreed that the retirement plan was an incentive for longer-tenured employees to remain with the State. Further, about three-quarters of employees near retirement eligibility agreed that the plan played a significant role in their decision to continue working for the State. Mercer's analysis of employee survey responses underscores how the importance of retirement benefits increases the longer an employee works. The VRS benefit is roughly 4.5 times more important for employees with more than 30 years of service than for employees with one to five years of service. Moreover, retiree health coverage is eight times more important to employees with more than 30 years of service than it is to shorter-tenured employees.

SPORS and VaLORS Benefits Aid Recruiting and Retention

> **Public Safety Occupations**
>
> Public safety is a generic term used to refer to the protection of public health and welfare. Public safety officers include certified law enforcement officers who protect the public through prevention and detection of crime, criminal justice officers who protect the public by managing convicted criminals and juvenile offenders, and emergency first responders, who protect the public by responding to fires, vehicle accidents, and medical emergencies.

Employees in public safety occupations appear to place more value on retirement benefits than other types of employees. Public safety recruits typically select their employer among various local, state, and federal agencies, most of which offer defined benefit plans with some degree of enhanced provisions. Even though public safety recruits may put more emphasis on retirement benefits than other prospective employees, employee survey data indicated that, once hired, public safety employees' opinions of their benefit does not vary significantly from that of other employees. However, differences between benefits offered under VaLORS and other enhanced plans (SPORS and LEOS) may impact the ability of some VaLORS law enforcement agencies to effectively recruit and retain employees, especially experienced police officers. Correctional VaLORS agencies have also reported difficulty retaining skilled employees because benefits are not fully portable to upper management positions.

State Retirement Benefits Are Competitive With Other Large Public and Private Employers

The effectiveness of the VRS retirement benefit as a recruiting and retention tool depends in part on its value relative to what other large employers offer. JLARC staff compared the VRS retirement benefits to retirement benefits in other states. JLARC staff also worked with PricewaterhouseCoopers (PwC) and Mercer to compare the value of the State's retirement benefits to those provided by other large public and private employers. Together, these analyses indicate that the value of VRS, SPORS, and VaLORS benefits are competitive with retirement benefits offered by other large employers.

> **Benefit Multiplier**
>
> A retirement plan's benefit multiplier is the percent of a member's average final compensation that he or she receives in retirement for every year of active service.

Nationally, states that participate in Social Security offer an average benefit multiplier of 1.97 percent. While this exceeds Virginia's benefit multiplier of 1.7 percent, most other state retirement systems also require employees to contribute to their benefit. Since 1983, Virginia has paid the member contribution on behalf of employees. As shown in Table 21, Tennessee is the only state neighboring Virginia that also does not require employees to contribute.

Regarding enhanced benefit plans, Florida, Tennessee, and Virginia are the only southeastern states that do not require employees to contribute to their retirement benefits. Both SPORS and VaLORS are more generous than the Tennessee plan, but less generous than the Florida plan. Of the remaining southeastern states, all but Georgia provide a traditional defined benefit plan that allow members of one or more public safety professions to

Table 21: Retirement Benefits and Employee Contributions in Neighboring States

State	Employee Contribution	Multiplier	Income Replacement Ratio[b]
Tennessee	0.0%	1.50%[a]	47%[a]
Virginia	0.0	1.70	51
Maryland	5.0	1.80	54
North Carolina	6.0	1.82	55
Kentucky	5.0	1.97	59
West Virginia	4.5	2.00	60

[a] In addition to a base multiplier of 1.5 percent, the amount of a Tennessee employee's Average Final Compensation that exceeds the Social Security Integration Level is multiplied by 0.25 percent and added to the base benefit. This benefit is then increased by five percent for the total benefit amount.
[b] Income replacement is defined as the proportion of Average Final Compensation the plan member earned while employed that is replaced by the income from the retirement benefit. The income replacement ratio is determined by an employee's years of service at retirement and the plan's benefit multiplier, defined above.

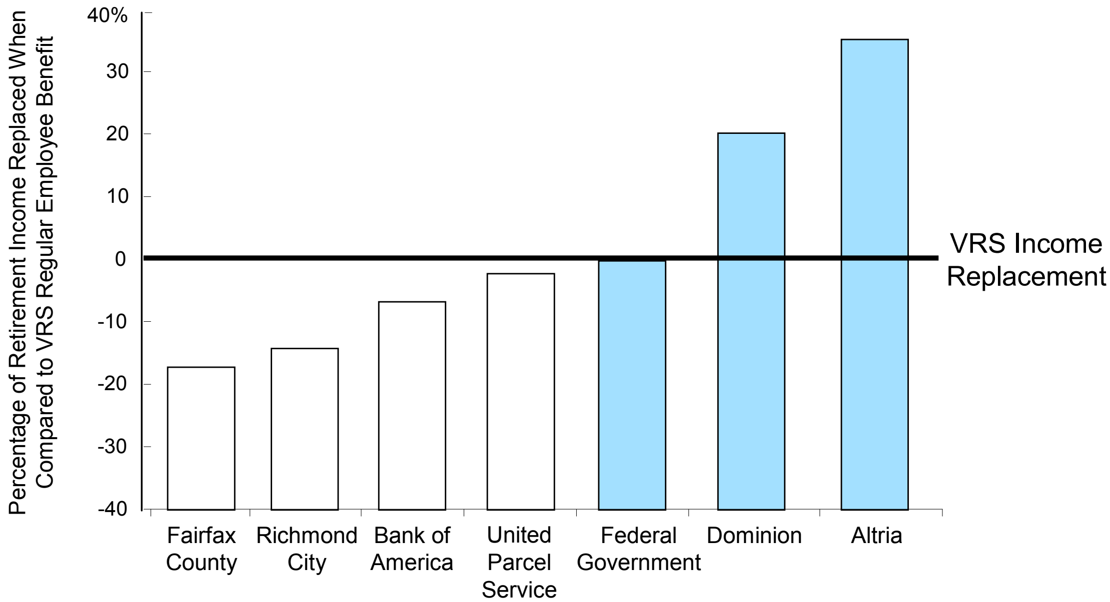
Source: JLARC staff analysis of surrounding states' pension plan documents.

retire with enhanced benefits. All of these plans require employee contributions, ranging from four to ten percent of salary.

PwC compared the level of income replacement provided by the retirement benefits of seven other large public and private employers that have a major presence in Virginia to what is provided by the regular VRS plan, SPORS, and VaLORS. As shown in Figure 14, taking into account that Virginia's retirement plan is noncontributory, PwC found that regular VRS benefits are comparable to the federal government and more generous than Fairfax County and Richmond City. SPORS benefits were found to be comparable to the federal government and Fairfax County, and more generous than Richmond City. VaLORS benefits were found to be comparable to the federal government, more generous than Richmond City, yet less generous than Fairfax County. PwC also found that VRS benefits are more generous than Bank of America and United Parcel Service, yet less generous than Altria and Dominion.

Mercer's independent assessment yielded similar results, providing further indication of the competitiveness of the VRS benefit. Mercer ranked the value of the VRS benefit sixth when compared to the 16 large peer employers in Virginia and third when compared to seven nearby states (these employers and states are listed in Chapters 2 and 4).

Figure 14: VRS Retirement Benefits Compare Favorably to Other Major Virginia Employers



Note: PwC analysis assumes an employee retiring with 30 years of service at age 65, employee contribution to a defined contribution account of six percent of salary (Virginia's 457 deferred compensation plan for VRS members), employer-specific match of employee contributions, eight percent return on investments, and full Social Security benefits.

Source: PricewaterhouseCoopers analysis of retirement plans offered to new hires.

MAJORITY OF EMPLOYEES RETIRE PRIOR TO NORMAL RETIREMENT AGE, VRS COMBINED WITH SOCIAL SECURITY PROVIDES ADEQUATE INCOME REPLACEMENT

Normal Retirement Age

The *Code of Virginia* provides that VRS members can first receive a full benefit at age 50 with 30 years of service. VRS members can also receive a full benefit at age 65 with five years of service – the *Code of Virginia* refers to age 65 as the "normal retirement age."

To receive unreduced retirement benefits, the State requires employees to achieve a certain combination of age and years of service. Employees in the regular VRS plan with at least 30 years of service have the option to retire anytime after the minimum retirement age of 50. The *Code of Virginia* sets the normal retirement age for the regular VRS plan at age 65, and employees may retire at 65 with at least five years of service. SPORS and VaLORS employees with at least 25 years of service have the option to retire anytime after the minimum retirement age of 50; with at least five years, they may retire at the plans' normal retirement age of 60.

Majority of Employees Retire Between Ages 50 and 65

JLARC staff analyzed the age and years of service of State employees who retired with unreduced benefits since the last reduction to the minimum retirement age in 1999. Table 22 shows that the majority of employees in VRS, SPORS, and VaLORS retired

Table 22: Majority of Recent Unreduced Benefit Retirements Occurred Prior to Normal Retirement Age (2000 - 2007)

Plan	Normal Retirement Age	% Retiring Prior to Normal Retirement Age	Average Age at Retirement	Average Years of Service at Retirement
Regular VRS	65	76%	62	30
SPORS	60	82	57	32
VaLORS	60	72	57	25

Source: JLARC staff analysis of VRS data, 2008.

prior to the normal retirement ages set forth in the *Code of Virginia*. Also, consistent with the intent of the enhanced plan designs, SPORS and VaLORS employees retired an average of five years earlier than employees in the regular VRS plan. VRS and VaLORS employees retired after a career consistent with the minimum number of years of service needed for unreduced benefits. SPORS employees averaged the highest years of service at 32 years of service prior to retirement.

VRS and Social Security Provide Adequate Income Replacement, Though Health Insurance Is Concern for Early Retirees

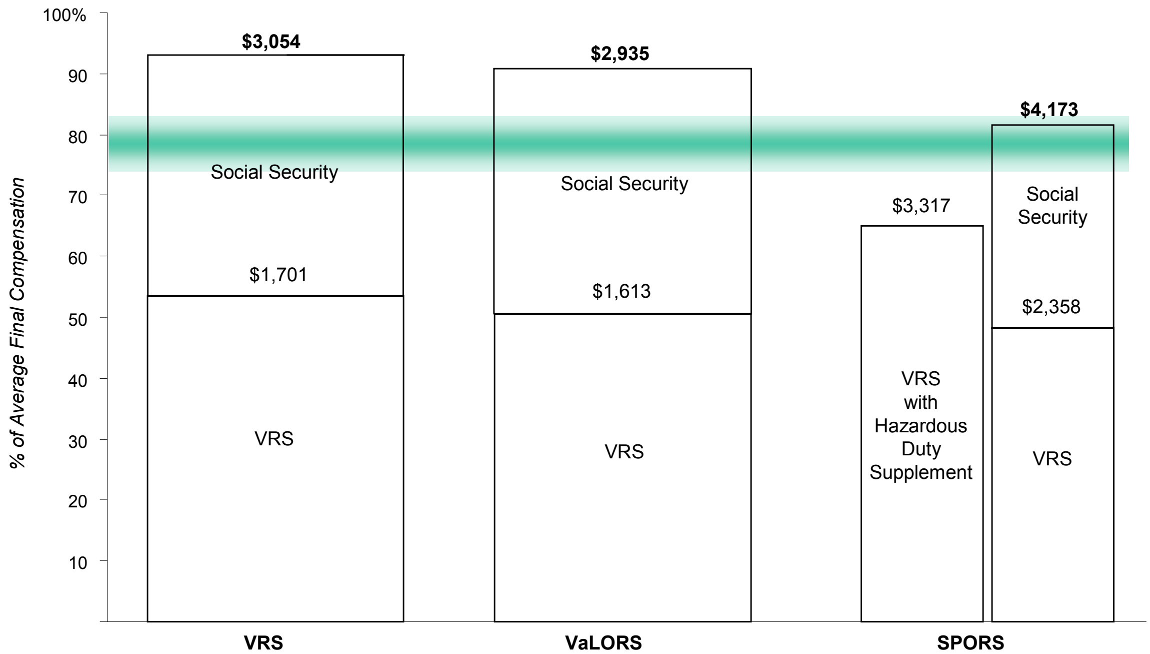
In addition to being eligible, employees also must be able to afford to retire. In FY 2007, the State paid $352 million in payroll taxes for employees to earn Social Security credits—underscoring the key linkage between the VRS benefit and Social Security. While the State has no specific targets for income replacement during retirement, 80 percent is widely cited in the financial community as sufficient. As shown in Figure 15, VRS and Social Security replace, on average, between 82 and 92 percent of pre-retirement income. On its own, the VRS benefit provides an income replacement of 51 percent after a full career. PWC analyzed the income replacement provided by VRS and Social Security (factoring in the non-contributory nature of the VRS plan) and found that "the current VRS program provides retirement benefits that exceed the traditional targets for career employees."

Advance Pension Option

Since 2005, the State has offered employees the advance pension benefit payout option. Retirees receive a temporary benefit increase until their normal Social Security age. The increase is based on the estimated amount of their Social Security benefit and results in a more level income prior to and during the collection of their Social Security benefits.

Despite adequate income replacement at Social Security age, employees express concern about health insurance costs once they retire. On the JLARC staff survey of classified State employees, three quarters of employees eligible to retire said that they had not yet retired because they could not afford to—the majority of these employees cited health insurance costs as the primary reason. The variation in health insurance premiums as a percentage of income between an active employee, ea6rly retiree, and retiree with Social Security and Medicare illustrates these employees' concerns.

Figure 15: VRS Combined With Social Security Replaces More Than 80 Percent of Pre-Retirement Income



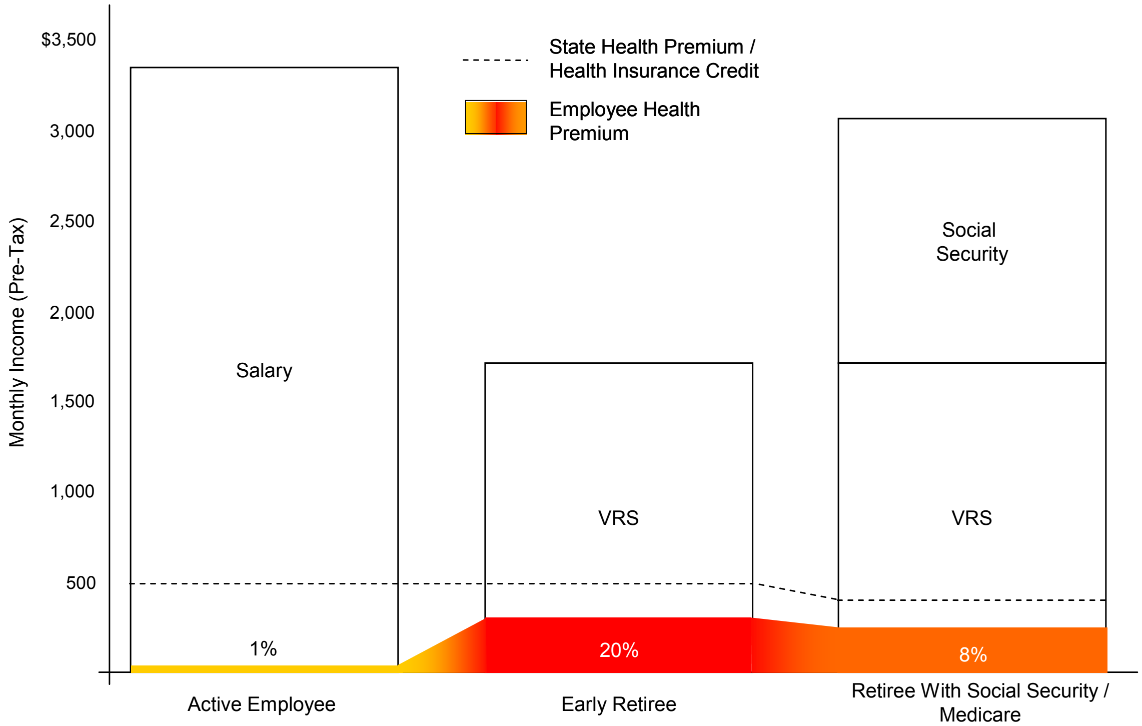
Note: VRS calculation based on 30 years of service for VRS and 25 years of service for VaLORS/SPORS and median Average Final Compensation for employees retiring in FY 2007 (VRS = $40,034, VaLORS = $38,720, SPORS = $61,179). Includes 1.85 percent multiplier and $959 hazardous duty supplement for SPORS, 1.7 percent multiplier for regular VRS, and 2.0 percent multiplier for VaLORS. Social Security calculation includes VRS retirement benefit based on 30 or 25 years and full Social Security benefit calculated for individual born in 1958 and working until age 66 years and eight months. Assumes retiring from State at Social Security retirement age.

Source: JLARC staff analysis of VRS data and Social Security Administration calculations.

As shown in Figure 16, employees who choose to retire early (prior to the normal retirement age and eligibility for Social Security and Medicare) experience a drop in income at the same time they become responsible for the entire portion of the health insurance premium. While the retiree health insurance credit is available to mitigate the impact of this increase, the employee portion of health insurance premiums still rises from about one percent of pre-tax monthly income for an active employee to about 20 percent for an early retiree. The increase is less substantial for employees who retire when they are eligible for Social Security and Medicare.

It is important to note that although early retirees are responsible for their total health premium, the State still provides an important benefit by pooling them with active employees. According to DHRM, early retirees' premiums are only 57 percent of what they would be without pooling them with active employees.

Figure 16: Employees Who Retire Early Experience a Substantial Increase in Percentage of Income Spent on Health Insurance Premiums



Source: JLARC staff analysis of VRS and DHRM data and documentation.

MAINTAINING STATE RETIREMENT PLANS REQUIRES SUSTAINED AND LONG-TERM FISCAL COMMITMENT

The VRS defined benefit plan is a competitive plan that provides employees an adequate retirement benefit. It also guarantees retirees a benefit from the time they retire until they or their beneficiary dies. Providing such a guarantee, however, requires the State to carry long-term financial liabilities. To pay for these long-term liabilities, the State must make annual contributions into the VRS trust fund. The State's required contributions are calculated as a percentage of the State's payroll and are based on an amount the VRS Board certifies as necessary to accumulate enough assets to cover 100 percent of the plans' liabilities. A defined benefit plan's financial health is measured through its funded ratio, which is the ratio of accumulated assets to actuarial liabilities.

The most recent VRS Board-certified contribution rates and funded status of the State retirement plans are shown in Table 23. In 2007, the regular State employees' retirement plan was funded at 85.1 percent of liabilities, slightly below the Public Fund Survey average of 86.2 percent. As shown in the table, contributions for VaLORS and SPORS are higher and their funded statuses are lower. This is primarily because of the lower age and years of

Table 23: State Retirement Plan Contributions and Funded Status

	Contributions as Percent of Payroll, 2008		Funded Status, 2007
	Employer	*Member (State-paid)*	
Regular VRS	6.15%	5%	85.1%
SPORS	20.76	5	73.8
VaLORS	15.86	5	65.7

Source: JLARC staff analysis of VRS documentation.

service required for an unreduced retirement benefit and higher benefit multiplier provisions of the two plans. Though these enhanced plans cost the State more per employee than the regular VRS plan, PwC found this cost "is an efficient use of State contributions" because their ability to retire at younger ages is necessitated by their responsibility for public safety.

Because of this higher per employee cost, it is important that the State place the appropriate employees in these enhanced plans. A JLARC staff assessment of enhanced plan membership found that SPORS membership is appropriate, but that VaLORS membership only partly aligns with established criteria. More information about this JLARC staff assessment of enhanced plan membership can be found in Appendix D.

OPEB Liabilities

In 2004, the Governmental Accounting Standards Board (GASB) issued Statement No. 45 which said that state and local governments should report unfunded liabilities, including for retiree health benefits, in their annual financial statements. GASB 45 has resulted in some states reducing those benefits to decrease their unfunded other post-employment benefit (OPEB) liabilities.

Recent regulatory changes have forced public pension plans to also report long-term liabilities associated with other post-employment benefits (OPEB), primarily related to retiree health insurance. According to a 2007 study by the PEW Center on the States, the average unfunded OPEB liability among all states was 135 percent of states' payrolls in FY 2006. Virginia's total OPEB liability represented about 62 percent of payroll and totaled approximately $2.3 billion as of FY 2006. One-quarter of Virginia's OPEB liabilities is attributable to promised retiree health insurance credit benefits. The State began pre-funding promised retiree health insurance credit reimbursements in FY 2008. As of June 30, 2007, the trust fund for State employees had assets sufficient to pay 17 percent of its liabilities for the health insurance credit.

History of Not Funding Recommended Annual Contributions Places Greater Burden on Future Taxpayers

Every two years the VRS actuary calculates the amount of funds the State should contribute to the retirement plans to pay for (1) the cost of benefits accrued by employees in that year and (2) a portion of the amount of unfunded liabilities from previously accrued benefits. This is called the Annual Required Contribution (ARC). The VRS Board must certify these rates, and in most cases it has certified the rates recommended by the actuary. The VRS Board-certified rates become the official rates that are cited in the Commonwealth's Annual Financial Report. Each year, the Governor and General Assembly allocate funds to cover the Board-certified rates, or some portion thereof.

There is no statutory requirement that the ARC be funded in a given year. However, the Governmental Accounting Standards Board (GASB) recommends that pension plan sponsors fully pay the ARC each year to ensure that the plan will eventually accumulate enough assets to pay for its total liabilities. Compliance with GASB recommendations is one factor bond rating agencies consider when issuing bond ratings.

According to PwC, "With the exception of fiscal year 2007, the funded ratio [for the VRS plans] has shown a constant pattern of decline, even during a period of favorable investment returns. This is because the State has chosen, for many years, not to fund the amount that the actuary determines each year." In the 18 years since the 1988-1990 biennium, the annual contributions to the retirement plans have been below what was certified by the VRS Board ten times. While the allocated annual contributions have been roughly equal the other eight times, this record demonstrates a historical unwillingness or inability to pay for the defined benefit promised to employees. During this time period, the cumulative shortfall between the VRS Board-certified contribution rates and contributions actually paid has been $526 million for the State employee plan alone. Given that VRS investment returns have historically outpaced inflation, VRS estimates the present value of those contributions—had they been made—could be as much as twice that amount, or $1 billion.

Virginia Compared to Other States

According to a report by the Pew Center on the States, between 1996 and 2007, states paid an average of 98 percent of the annual required contributions for their respective pensions plans and 25 states paid 100 percent or more. Across that time period, Virginia averaged 80 percent, ranking it 46th among the 50 states.

When calculating plan liabilities, the VRS actuary assumes the State will contribute 100 percent of the recommended ARC each year. But recent history has shown this assumption only holds true in the minority of cases. According to PwC, "Given that the State typically contributes less than the actuarially determined contribution rate, we expect that the funded ratios will continue to decline." If the trend of paying less than the ARC continues, the resulting decline in funded ratios will require future generations of taxpayers to bear a larger portion of the liabilities associated with providing retirement benefits to current employees.

These liabilities manifest themselves in the form of a higher ARC in years to come. For illustrative purposes, PwC recalculated the VRS projections of future ARCs (Table 24). By PwC's calculations, funding 75 percent rather than the full ARC results in rates being 18 percent higher by 2016 for the State employee plan. Based on

Table 24: Historical Shortfalls in Funding for VRS Board-Certified Rates Necessitate Higher Contributions in Future Years

	Projected Rates as % of Payroll in 2016		Difference Between 100% and 75% Paid	
	If 100% Paid	*If 75% Paid*	*%*	*$ (millions)*
Regular VRS	7.6%	9.0%	18.4%	$60.0
SPORS	19.3	22.8	18.1	4.3
VaLORS	17.8	20.7	16.3	11.9

Note: Based on projected payroll in 2016.

Source: PricewaterhouseCoopers 2008 and VRS projections of State employee payroll.

the projected payroll, this amounts to an ARC of approximately $60 million more than if 100 percent of the ARC is paid. This substantial difference in the required contribution—even over a relatively short period of time—underscores the budgetary impact of creating larger liabilities for future taxpayers by not fully funding the required ARC.

State-Paid Member Contribution and COLA Constitute Substantial Portion of Benefit Costs

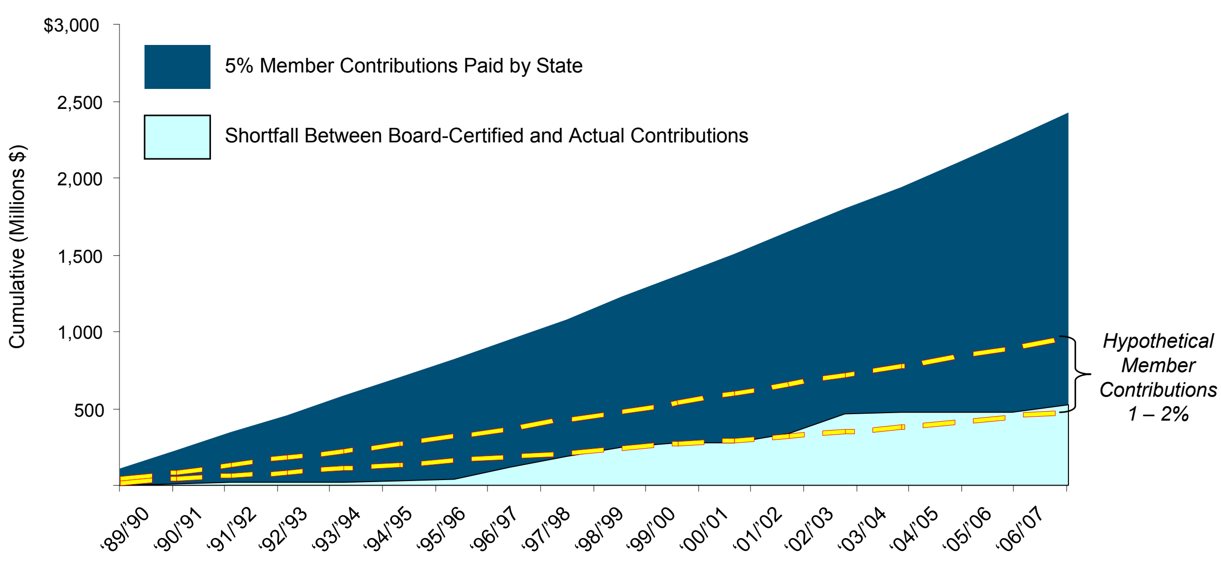
Two provisions of the VRS retirement plan were most frequently cited by employees as being its most attractive aspects: (1) the VRS benefit is guaranteed and (2) they do not have to pay into the plan to receive their VRS benefit. Not surprisingly, these two aspects of the plan are also among the largest drivers of State costs. As noted above, since 1983 the State has paid both the employer contribution and the five percent member contribution on behalf of its employees. This was done in lieu of a salary increase for employees that year, resulting in a one-time deferral of approximately $3.4 million in federal payroll taxes. In FY 2007, the five percent member contribution totaled $168.2 million for the State employee plan, roughly 42 percent of total FY 2007 contributions to the plan. According to PwC, "the non-contributory nature of the VRS plan…significantly increases the value and cost of the VRS benefit."

Whereas there is no requirement that the State pay the ARC, the *Code of Virginia* does require that the member contribution be paid. Of the ten times the VRS Board-certified ARC has not been fully paid in the last 18 years, the shortfall was always less than the five percent member contribution that the State was required to make that year. Had the State not been obligated to pay the five percent member contribution in addition to the ARC, previous Governors or General Assemblies may have been more willing or able to fully fund the required employer contribution. In fact, the cumulative difference between VRS Board-certified and actual contributions since the 1988-1990 biennium could have been easily closed with member contributions paid by employees of between one and two percent of payroll (Figure 17). The consequent improved funded status would have resulted in the VRS actuary recommending lower ARCs in ensuing years, improving the State's ability to fully fund the plan's liabilities.

Another driver of State costs is the cost of living adjustment (COLA), which is designed to protect the purchasing power of the guaranteed benefit. Since 1979, the VRS benefit has maintained roughly three-quarters of a retiree's purchasing power. Had the State not applied a COLA to the VRS benefit, a retiree would have lost about two-thirds of his or her purchasing power during that time. In fact, the value of the COLA can be so considerable over time that for some lower-income retirees, the amount of the COLA they receive is now larger than their original benefit.

This protection of purchasing power comes at a cost, however. PwC estimates that funding the COLA represents approximately 20 percent of the present value of future VRS retirement benefits. PwC noted that while the COLA is "very helpful in enabling employees to retire at the right time," the current COLA is not "an efficient use of available funds" because it does not substantially aid the State's recruitment and retention goals. In fact, JLARC staff found that Virginia's COLA is greater than those granted by all neighboring states' retirement systems, which place a lower cap on the COLA or provide no guaranteed benefit adjustment at all.

Figure 17: Member Contributions Between 1% and 2% of Payroll Would Have Covered Shortfall Between VRS Board-Certified and Actual Contributions



Source: JLARC analysis of VRS data, 2008.

OPTIONS TO MODERATELY REDUCE FUTURE FINANCIAL LIABILITIES AND ENSURE THAT PLAN CONTINUES TO ACHIEVE PURPOSES

As shown in Table 25, the State's current approach to retirement benefits is mostly achieving its purposes of recruiting, retaining, and allowing employees to retire with adequate benefits. However, there is a historical tendency for the contributions to the VRS retirement plan to be funded at less than the amount actuarially recommended. If this trend continues, the liabilities to pay for the retirement benefits promised to current employees will continue to be pushed onto future generations in the form of higher State contributions, or will have to be off-set by higher than assumed investment returns.

Based on this assessment of the State's current retirement benefits, JLARC staff and PwC have developed four moderate options to reduce the level of future financial risk confronting the plans, thereby increasing the likelihood that the current plan design—noted above as mostly achieving the State's purposes—can be sustained.

Table 25: Summary Assessment of Current Approach to Retirement Benefits

	Purposes			Cost	
	Recruit	*Retain*	*Retire*	*Current $ (millions)*	*Future $ Risk Level*
Regular VRS	●	●	●	$397	Medium
SPORS	●	●	●	22	Medium
VaLORS	●	●	●	68	Medium

Legend for Scale of Purpose Achieved | ● Mostly | ◐ Partially | ○ Minimally

Note: Cost includes State and State-paid member contributions for defined benefit programs and retiree health insurance credit program in FY 2007. Cash match payments under the 457 program are not shown.

Source: JLARC staff assessment, 2008, and VRS records for FY 2007.

Option R1: Require Employees to Contribute Into VRS

As noted previously, PwC found that noncontributory defined benefit plans are rare among government employers. This fact, along with the historical tendency for VRS to be funded at less than the actuarially recommended amount, makes requiring employees to contribute towards their VRS benefits a reasonable option when seeking to ensure the VRS benefit program is sustainable over the long term. Over the last 18 years, an employee contribution of between one and two percent of payroll would have closed the gap between the VRS Board-certified ARC and what was actually contributed.

Because of the tax-deferred treatment of the State-paid member contributions prior to 1983, IRS rules prohibit the State from requiring employees to again pay the five percent member contribution. However, new contributions in addition to the five percent are allowable. To accomplish this, the General Assembly could amend the *Code of Virginia* to increase the member contribution from five to seven percent of payroll. The additional two percent member contribution would be deducted from active employees' salaries on a pre-tax basis, while the State would continue to pay the five percent portion on behalf of employees.

Not having to contribute into the plan was one of the most attractive attributes of the VRS plan for employees. As a result, this reduction in take-home pay would not be welcomed by employees. For the average State employee making $42,142 per year, this two percent contribution would be $843, or about $35 per pay period. The contribution would be pre-tax, which would reduce the employee's taxable income, thereby lowering their tax liability. The two percent employee contribution increase could be phased in over time, for example, in 0.5 percent increments during years in which the General Assembly provides an annual salary increase to employees. Further, because this is an employee contribution, employees would still own the contributions (along with the five percent that the State currently contributes on their behalf) and would be entitled to a refund with four percent interest if they choose to leave State service and forfeit future VRS benefits. For regular VRS members, this would result in, at times, more than half of the total contributions into VRS being owned by employees.

PwC estimates that this option, when fully implemented, would result in a roughly commensurate two percent reduction in the required ARC as a percentage of payroll. Based on the projected payrolls for VRS, SPORS, and VaLORS in 2013 (assuming the two percent contribution is fully implemented five years from now), this option would result in a cost avoidance for the State of approximately $89 million that year.

Option R2: Reduce the COLA Granted to Future Retirees

Currently, retirees receive a COLA that is equal to the first three percent of the increase in the Consumer Price Index, plus half of each percent increase from three percent to seven percent. As noted previously, the COLA represents roughly 20 percent of plan costs. To reduce plan cost and risk, the General Assembly could reduce the COLA for future retirees. Under this option, future retirees would be guaranteed a COLA equal to the first two percent increase in the CPI, plus half of each percent increase from two percent to four percent. Here again, the guaranteed nature of the VRS benefit was one of the most attractive attributes of the current plan, so a change to the COLA would likely not be welcomed by employees.

To illustrate the impact of this change over a 30-year retirement, JLARC staff compared the monthly benefits from the actual COLAs that retirees have been granted since 1978 to what would have been granted under this option. Ten years after retiring, this reduced COLA would have resulted in a benefit approximately six percent below the current approach. This gap would have doubled to about 12 percent after 30 years. According to PwC the COLA under this option will still be "very helpful in enabling employees to retire at the right time with adequate income for life." Importantly, employees would still continue to receive an additional COLA in their Social Security benefit.

While PwC's assessment of this option is that this change will not have a substantially adverse impact on future retirees' income or active employees' ability to retire, the General Assembly could consider exempting active employees within several years of retirement eligibility from this change. Such an exemption could help limit the extent to which employees in this group may have to alter their retirement plans. This exemption could also help avoid a sudden increase in employee retirement—and therefore loss of experienced employees—just prior to the effective date.

PwC estimates that this option, if applied to all future retirees, would reduce the COLA from 20 percent to about 13 percent of plan costs. This would result in an ARC that is between one and two percent of payroll less than the current approach. Based on the projected payrolls for VRS, SPORS, and VaLORS in 2013, this option would result in a cost avoidance of approximately $54 million in that year.

Other States' Adjustments to Defined Benefit Plans

In Kentucky, after September 1, 2008, retirees will receive a less generous COLA. In 2007, Kansas raised the minimum retirement age for its employees and increased employee contributions to the retirement plan. Louisiana and Texas increased the minimum retirement age to 60 in 2006. And in 2005, Arkansas began requiring employees to contribute to their defined benefit plan.

Option R3: Increase Minimum Retirement Age for Non-Vested and Newly-Hired Regular VRS Employees to 60

The minimum retirement age prior to 1987 was 60, which was lowered to 55 in 1987, and then lowered again to 50 in 1999. In contrast, the federal government has incrementally increased the minimum age to collect Social Security benefits, which now stands at age 67 for people born after 1960. What was a five-year difference between the VRS minimum retirement age and Social Security retirement age prior to 1987 is now a gap of 17 years. Recently, the American Academy of Actuaries recommended that the federal government further increase the Social Security normal retirement age due to increasing life expectancies. According to PwC, "… over time, eligibility for retirement benefits will be increased to older ages."

To be consistent with this national trend and reduce cost and risk to the State, the General Assembly could consider increasing the minimum age at which non-vested and newly-hired regular VRS members become eligible for full retirement benefits from age 50 to age 60. This change would be consistent with increasing life expectancies and the fact that employees currently retire with full benefits at an average age of 62. The General Assembly could also consider increasing the normal retirement age for newly-hired regular VRS employees from 65 to 67. Such a change would further enhance the link in plan designs between VRS and Social Security, which together result in adequate income replacement. However, any increase to the age at which employees become eligible for full retirement benefits would impact the effectiveness of return-to-work initiatives employed by agencies to address staffing challenges (see Appendix B for further discussion of return-to-work.) The changes under this option would not apply to those in SPORS and VaLORS.

PwC estimates that once all employees fall under the new minimum age requirement for full benefits, this option would result in an ARC that is ultimately about 0.5 percent of payroll lower than the current approach.

Option R4: Replace Retiree Health Insurance Credit With Integral Part Trust for Newly-Hired and Non-Vested State Employees

Of the classified employee survey respondents who reported that they could not retire, the majority cited the cost of health insurance in retirement as the primary reason. Another option that would only apply to newly-hired employees would be to replace the retiree health insurance credit with an integral part trust (IPT) retirement health savings account. Conceptually, this would shift employees from the defined benefit design of the credit to a defined contribution design of an IPT. In addition to reducing the State's OPEB liabilities, this option would give employees who wish to retire prior to the normal retirement age the choice to draw down additional funds to cover health insurance costs prior to being eligible for Medicare.

Historically, the State has attempted to address retirees' concerns about the cost of health insurance by increasing the amount of the retiree health insurance credit. However, this approach results in increasing the State's OPEB liability to address the relatively short-term concerns of early retirees who are not yet eligible for Medicare. Moreover, because the credit remains unchanged unless the *Code of Virginia* is amended, it is highly likely that the current value of the credit will be eroded unless it is increased at a rate sufficient to account for future increases in health insurance costs.

Under this option, all newly hired and non-vested employees would be placed under an IPT system rather than be eligible for the retiree health insurance credit. Contributions for these employees that would have been placed in the health credit trust fund would instead be set aside in an employee IPT account. When retired, an employee would receive tax-free distributions from their IPT account at an amount of their choosing. Employees wishing to retire early could withdraw larger portions of their IPT when health insurance premiums represent a greater portion of their income. This, unlike the current retiree health insurance credit, would give retirees flexibility in how they use their benefit. However, the IPT would also require retirees to manage their account balance to ensure they have funds available throughout retirement, which means that employees bear a greater risk for saving and planning for these expenses than they would under the current health insurance credit program.

While the IPT account may provide retirees with greater flexibility in budgeting for health-care costs, the assumed account balance drawn down over the duration of retirement would still cover only a portion of health premiums. This could be addressed by making higher contributions into the IPT account during employment. Minnesota, which has an IPT, received a private letter ruling from the IRS that allows for employee contributions to an IPT account. However, these contributions are mandatory for all employees.

Minnesota's IPT

In 2001, Minnesota implemented an Integral Part Trust for its employees. Contributions to employees' accounts vary in amount and type depending on the employee group, but primarily consist of excess leave balances or employee contributions. According to Minnesota Retirement System staff, employees are satisfied with this program.

From the State's perspective, this option would increase the administrative complexity when compared to the current approach. But, over time, this option would reduce the State's long-term liability associated with retiree health insurance. In the near-term, however, because no more employees will be entering the system for the retiree health insurance credit, the current trust fund's existing liabilities will be spread over a decreasing number of active members. This could for a period of time increase the required contribution into the credit trust fund as a percent of covered payroll. Before implementing this option, PwC has advised that the State seek a private letter ruling from the Internal Revenue Service on the permissibility of whatever approach the State selects to structuring the IPT.

Options Minimally Impact Purposes, Reduce State Cost and Risk

As shown in Table 26, each of the four options described above would have a minimal impact on the State's purposes to recruit, retain, and allow employees to retire with adequate benefits. Yet, ultimately these options would result in considerably lower future ARCs when measured as a percentage of future payroll. For example, assuming options R1 and R2 are fully implemented by 2013, required State contributions into VRS, SPORS, and VaLORS could

Table 26: Projected Impact of Options to Moderately Reduce Future Financial Risk and Ensure That Purposes Continue to Be Achieved – VRS, SPORS, and VaLORS

Option	State Employees Affected	Purposes			Cost	
		Recruit	*Retain*	*Retire*	*Eventual Reduction in Required State Contributions (As % of Future Payroll)*	*Future $ Risk Level*
Require employees to contribute into VRS (R1)	All VRS, SPORS, VaLORS	↔	↔	↔	VRS = 1.95% SPORS = 1.98 VaLORS = 1.94	Lower
Reduce COLA for future retirees (R2)	All VRS, SPORS, VaLORS	↔	↔	↔	VRS = 1.15 SPORS = 2.02 VaLORS = 1.31	Lower
Increase minimum retirement age to 60 (R3)	Newly-hired and non-vested VRS	↔	↔	↔	VRS = 0.45	Lower
Replace credit with IPT (R4)	Newly-hired and non-vested VRS, SPORS, and VaLORS	↔	↔	↔	None	Lower

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful

Note: The resulting reduction in State contributions to the retirement as a percent of payroll would be applied to the payroll comprising all State employees who are VRS members.

Source: JLARC staff and PricewaterhouseCoopers analysis, 2008.

be approximately $143 million lower in 2013 when compared to projections if no changes are made.

Teacher Retirement Funding

The State reimburses localities for 55 percent of the cost of retirement benefits for the number of teachers required by the State Standards of Quality (SOQ). The amount is calculated as a percent of total SOQ-covered salaries, but some localities pay higher salaries using local funds. Included in the total SOQ salary figure are only those positions funded by the SOQ— 38 percent of VRS-covered schoolteachers are not recognized in the SOQ.

Applying Options to Teacher Plan and Political Subdivision Plans Could Further Reduce Future Financial Risk, Preserve Administrative Efficiencies

As noted earlier, VRS also administers the retirement benefits for Virginia's schoolteachers, which represent the largest cohort of active VRS membership. At the end of FY 2007, the teachers' retirement plan had a funded status of 78.2 percent. Teachers' retirement benefits represent a substantial portion of State spending because the State reimburses localities for approximately 55 percent of their retirement benefit contributions for teachers required by the State Standards of Quality (SOQ) ($200.4 million in FY 2007). Because of this substantial amount of State funding, and to preserve administrative efficiencies from similar plan design, JLARC staff asked PwC to also calculate the cost avoidances if the above options were also applied to the teacher plan.

As shown in Table 27, the above options would ultimately result in a considerably lower future ARC for teachers' benefits when measured as a percentage of future payroll. By 2013, State reimburse-

Table 27: Projected Impact of Options to Moderately Reduce Future Financial Risk and Ensure That Purposes Continue to Be Achieved – Schoolteachers

Option	Teachers Affected	Cost	
		Eventual Reduction in Required Contributions to VRS (As % of Future Payroll)	*Future $ Risk Level*
Require employees to contribute into VRS (R1)	All VRS-covered teachers	1.97%	Lower
Reduce COLA for future retirees (R2)	All VRS-covered teachers	1.36	Lower
Increase minimum retirement age to 60 (R3)	Newly-hired and non-vested VRS-covered teachers	0.88	Lower
Replace credit with IPT (R4)	Newly-hired and non-vested VRS-covered teachers	Minimal	Lower

Note: Reduction in State required contributions will be 55 percent of the total reduction and will be based on the proportion of payroll for the Teacher plan funded by the State for SOQ-funded instructional positions (59 percent in FY 2007).

Source: JLARC staff and PricewaterhouseCoopers analysis, 2008.

ments could be reduced by as much as approximately $71 million. For localities, these lower future ARCs could yield an ultimate cost avoidance of as much as approximately $180 million.

PwC did not calculate the impact of these options if they were applied to the retirement plans of the more than 500 political subdivisions participating in VRS—this would require a separate actuarial analysis for each option and plan. However, applying any changes that are made to the retirement plans for State employees and teachers to political subdivisions that participate in VRS would further serve to preserve current administrative efficiencies. This would also result in reducing the costs and long-term financial risk associated with the current plan for political subdivision employers, nearly half of which are local governments. It should be noted that while there is no requirement that the State fully fund the contribution rates recommended by the VRS actuary, political subdivisions are required to fully fund their recommended contribution rates. As such, political subdivisions' defined benefit plans have a higher funded status than the State plans. If option R1 were to apply to political subdivisions, the additional member contribution should not result in total contributions exceeding the cost of these plans because they might then be permanently overfunded.

OPTIONS TO MORE AGGRESSIVELY CHANGE VRS PLAN DESIGN

Based on the JLARC staff, PwC, and Mercer assessments, the current defined benefit plans effectively achieve their purposes. However, there are alternative retirement plan designs that would more aggressively change the current defined benefit plan design of VRS. These include a defined contribution plan or a hybrid / combination of a defined benefit and defined contribution plan. JLARC staff and PwC identified an illustrative "combination" plan, "cash balance" plan, and defined contribution plan for newly hired State employees. PwC's analysis of the fiscal impact of these alternative plan designs was based on the workforce, plan membership data, and assumptions for FY 2007. If the General Assembly wishes to pursue implementation of these alternative plan designs, it should request that the VRS actuary recalculate the cost impact based on the most recent assumptions available.

Other States Trying Alternative Plan Designs

As of 2007, 13 states had implemented retirement plans for public employees that serve as alternatives to defined benefit plans. Five states now *require* new hires to participate in new hybrid or defined contribution plans, and the other eight offer new employees a *choice* between the new plan and the traditional defined benefit plan. Among those states that offer employees a choice, a minority of newly-hired employees elected to join the defined contribution or hybrid plan.

Despite the shift away from defined benefit plans in the private sector, they remain the dominant plan design in the public sector. According to the Center for Retirement Research at Boston College, more than 95 percent of public workers are in defined benefit plans. PwC noted that the challenges confronting the private sector that forced many to move away from defined benefit plans do not apply to the public sector, and "the efficiencies of defined benefit plan[s] suggest their continuance as the primary vehicle for providing benefits in the public sector."

The JLARC staff and PwC assessment of combination, cash balance, and defined contribution plans finds that each of these plans, to respectively increasing degrees, shift the burden of achieving an adequate retirement income towards employees. Of the three alternatives, the combination plan shifts the least amount of risk to the employee because although it provides a lower benefit than the current defined benefit plan, that portion of the benefit is still guaranteed. The defined contribution design shifts the greatest amount of risk to the employee because the benefit amount depends on individual employee contributions and investment earnings, neither of which are guaranteed. Because of this shift in financial risk, each these alternatives yield lower replacement ratios than the current plan as an employee reaches retirement age. Lower income replacement will likely result in some employees working for a longer time than they would under the current defined benefit plan. (These options do not include SPORS and VaLORS employees because their ability to retire at younger ages is necessitated by their responsibility for public safety.) However, for the State this shift in financial risk means lower required contributions toward retirement benefits and decreased long-term financial risk. Moreover, despite lower retirement benefits, these alternative plan designs would allow employees more portability and flexibility with their retirement savings.

Importantly, each of the options described below would apply only to newly-hired employees and current employees in the standard VRS plan who are not yet vested in their VRS benefit. This is because changes to the basic structure of the State's retirement plans could be subject to legal challenge by vested employees. Limiting the change to non-vested employees likely makes implementing these alternatives somewhat easier because they will affect only a small portion of the current workforce. Yet this also means that the reduction in annual costs and long-term risk associated with these alternatives does not fully materialize for decades—until the last active employee in the current plan has retired and the active workforce is covered under the new plan. In addition, there will be increased administrative cost and complexity during this lengthy transition period while the State concurrently maintains multiple plan designs.

Option R5: Create a New Combination Plan

A combination plan includes both defined benefit and defined contribution components.

The most well-known example of a public employer implementing a "combination" retirement plan is the federal government's creation of the Federal Employees' Retirement System. A combination plan includes both defined benefit and defined contribution components. The defined benefit component—which is the guaranteed portion of the benefit—is typically lower than what is provided by a defined-benefit only plan. To compensate, a more robust defined contribution component is offered, which usually includes an employer match of a percentage of employee contributions. This plan can be attractive to both the employer and employee because while it shifts more of the financial risk of retirement savings to the employee, thereby lowering long-term employer cost, it still provides employees a guaranteed retirement income as well as the flexibility and portability of a defined contribution savings plan. Six states—Ohio, Washington, Oregon, Indiana, and Georgia—have decided to offer their employees a combination plan rather than a defined benefit plan.

JLARC staff and PwC developed an illustrative combination plan closely mirroring these other public employer combination plans. This illustrative plan features a 1.0 percent defined benefit multiplier and requires an employee contribution to the defined benefit plan of one percent of salary. Employees would be eligible for an unreduced benefit from the defined benefit portion of the plan at age 60 and with 30 years of service. The plan also includes a defined contribution component under which the State would match all employee contributions up to three percent of salary and half of the next four percent of employee contributions (up to a maximum five percent match).

PwC's analysis of this illustrative combination plan shows that after 30 years of service, the combination plan would provide approximately 85 percent of the value of the current defined benefit plan. With Social Security, the combination plan would provide an income replacement of approximately nine percent less than the current defined benefit plan. This could be lower or higher depending on the amount of an employee's contributions and rate of return the employee is able to earn on these contributions. (Figure 19 at the end of this section compares the value accumulated and income replaced to the current defined benefit plan).

Because this plan would apply only to non-vested and newly-hired employees, there would be a transition period lasting several decades. During this transition period, PwC indicates that a combination plan would have substantial administrative costs, largely because VRS will be simultaneously administering two different defined benefit plans, in addition to a new defined contribution plan. PwC estimates that once all State employees are in the combination plan the employer contribution will be 1.94 percent of payroll less than the current approach.

Option R6: Create a New Cash Balance Plan

A cash balance plan is "like a defined contribution plan, but retains the funding and accounting flexibility of a defined benefit plan."

According to PwC, a cash balance plan is "like a defined contribution plan, but retains the funding and accounting flexibility of a defined benefit plan." Cash balance plans have the portability and lump-sum distribution features of a defined contribution plan, but the employer still guarantees that the employee will receive a predetermined benefit amount. Cash balance plans exhibit the account accumulation approach of a defined contribution plan and mitigate the risk that the employee would make poor investment decisions during their career by guaranteeing a consistent, annual rate of return. This rate of return is typically above the relatively low rate of return on most basic savings accounts (for example, two to three percent), but below the rate of return that can be achieved by large pension funds such as VRS over the long-term (assumed 7.5 percent).

According to PwC, cash balance plans are rare in both the public and private sectors because of past negative publicity about the accounting practices used by employers that converted their retirement plans to cash balance plans. However, PwC found that recent regulatory changes have eliminated past concerns, and this type of plan may grow in popularity. Currently, Nebraska is the only state that has implemented a cash balance plan.

JLARC staff and PwC developed an illustrative cash balance plan in which employees would contribute five percent of salary to their own account and receive employer contributions. To facilitate the State's goal of using the retirement plan to help retain longer-tenured employees, these employer contributions would increase along with the employee's tenure as shown in Table 28. The accounts would accrue a guaranteed five percent interest. If separating from State service after meeting the vesting requirements, the employee could withdraw the entire account balance in a lump sum. Prior to vesting, the employee could withdraw the employee contributions with interest or could roll their account balance over to another qualified plan. Unlike under the defined benefit plan, retirees under the cash balance plan would not receive a COLA.

Table 28: State Contributions Under Cash Balance Plan Option

Tenure (Years)	State Contribution (As % of Salary)
0 – 10	7%
11-20	10
21-30	13
30 or more	16

Source: PricewaterhouseCoopers.

PwC's analysis of this illustrative cash balance plan shows that after 30 years of service, the cash balance plan would have approximately 57 percent of the value of the current defined benefit plan. With Social Security, the cash balance plan would also provide an income replacement of approximately 27 percent less than the current defined benefit plan (Figure 19 at the end of this section compares the value accumulated and income replaced to the current defined benefit plan).

Because this plan would apply only to non-vested and newly-hired employees, there would be a transition period lasting several decades. During this transition period, PwC indicates that a cash balance plan would have additional administrative costs, largely due to the need to educate employees about the accrual patterns of the new plan and likelihood that more VRS staff would be needed to administer the new plan. PwC estimates that once all State employees are in the cash balance plan, the ARC will be 3.33 percent of payroll less than the current approach.

Option R7: Create a New Defined Contribution Plan

Defined contribution plans provide the greatest degree of portability and flexibility for employees. However, defined contribution plans also typically result in lower income replacement when compared to defined benefit plans. This is primarily because individual employees historically achieve lower investment returns than what large pension funds can achieve. While the defined contribution plan results in greater flexibility because there is no retirement age associated with the plan (though IRS penalties for early withdrawal apply), volatile investment returns can significantly alter an employee's planned retirement date. In contrast, defined benefit plans are large enough to pool investment risks across thousands of people and timeframes of decades, eliminating the impact of volatile near-term investment returns on an individual employee's decision to retire.

Currently, two states (Alaska and Michigan) have implemented mandatory defined contribution plans for newly-hired employees. West Virginia and Nebraska used to provide a mandatory defined contribution plan for their employees, but have since replaced those plans with a defined benefit and a cash balance plan, respectively. Several other states provide employees with a choice between a defined contribution and a defined benefit plan design.

According to PwC, "Many of the issues that have caused private sector employers to shift to defined contribution…plans are not as applicable (or applicable at all) to public sector employers." Foremost, private sector employers must comply with accounting and plan funding rules that, according to PwC, do not favor defined benefit plans. However, these regulations do not apply to public sector employers, which "has resulted in less volatility in public sector plans." Second, PwC observed that "private sector employers are very concerned with the reaction Wall Street might have if projected earnings are not met…and defined benefit pension plan cost volatility contributes to these pressures." Because public sector employers are "perpetual entities" that will not go out of business, "there is considerably less concern if the cost of a benefit program does not meet expectations for a short period of time." Finally, according to PwC, the greater mobility of the private sector workforce necessitated a switch to a more portable retirement plan design. Public employees, on the other hand, "are likely to spend more years of service with a single employer than in the private sector. While a defined contribution plan is advantageous in the private sector because it pays higher benefits to short-service employees, it results in lower benefits for the majority of public sector employees."

Public vs. Private Sector Workforce

According to the U.S. Census Bureau's 2004 Current Population Survey, the median tenure for public sector employees is over 50 percent longer than the median tenure for private sector employees.

Defined contribution retirement plans can be attractive to employers because they result in more predictable and stable employer costs—whereas contributions to defined benefit plans vary each year based on actuarial assumptions, defined contribution plan costs remain the same. However, because contributions to defined benefit plans have no direct impact on the amount of employees' retirement benefits, employers have been able to exercise greater discretion in their funding practices for defined benefit plans. Conversely, under a defined contribution plan, the employer typically has less flexibility in making the expected employer contribution because the employer contribution, in part, determines the ultimate amount of employees' retirement savings.

JLARC staff and PwC developed an illustrative defined contribution plan that assumed five percent employee contributions and employer contributions that increase based on years of service as shown in Table 29. The contributions assumed are less than those assumed in the cash balance plan, primarily because lower employer funding is needed due to the higher rate of return assumed in the defined contribution plan (7.5 percent VRS return for the defined contribution plan as compared with a five percent return for the cash balance plan).

Table 29: State Contributions Under Defined Contribution Plan Option

Tenure (Years)	State Contribution (As % of Salary)
0 – 10	3%
11 – 20	4
21 – 30	5
30 or more	7

Source: PricewaterhouseCoopers.

The 7.5 percent long-term investment return assumption is due to the fact that employee and employer funds would be automatically invested in the VRS Investment Portfolio option currently offered in the 457 deferred compensation plan. However, employees would be ultimately responsible for their investment decisions and could opt-out of the VRS Investment Portfolio. Employees would become vested in their account balance immediately and could either withdraw a lump sum when they leave State service, roll the account balance over to another defined contribution account, or leave their balances in the plan and draw periodic distributions. As with the cash balance plan, retirees under the defined contribution plan would not receive a COLA.

Virginia Experiences With Defined Contribution Plans

In 1988, the City of Alexandria began enrolling its local police into a defined contribution retirement plan. However, employees' dissatisfaction over investing challenges, including low earnings, prompted the city to reinstitute its former defined benefit plan in 2004.

In 2003, the City of Richmond introduced a defined contribution plan as an optional alternative to its defined benefit plan. In 2006, the defined contribution plan was made mandatory for new employees.

PwC's analysis of this illustrative defined contribution plan shows that after 30 years of service, the defined contribution plan would have approximately 52 percent of the value of the current defined benefit plan. With Social Security, the defined contribution plan would also provide an income replacement of approximately 29 percent less than the current defined benefit plan. This could be lower or higher depending on the amount of an employee's contributions and rate of return the employee is able to earn on these contributions. (Figure 19, page 109, compares the value accumulated and income replaced to the current defined benefit plan.)

Because this plan would apply only to non-vested and newly-hired employees, there would be a transition period lasting several decades. During this transition period, PwC indicates that a defined contribution plan would have additional administrative costs, largely due to the need to educate employees about the need to contribute a sufficient amount to their accounts to ensure an adequate retirement benefit. PwC estimates that once all State employees are in the defined contribution plan, the employer contribution will be 4.94 percent of payroll less than the current approach.

Options Could Hinder Recruiting, Retention, and Retirement With Adequate Benefits, Yet Reduce Long-Term State Costs and Risk

As shown in Table 30, each of these options would have either a minimal or negative impact on the State's goals of recruiting, retaining, and allowing employees to retire with adequate benefits. Yet, over the very long term these options lower both the annual cost and level of financial risk to the State associated with providing retirement benefits to employees. As shown in Figure 19, the combination plan, cash balance plan, and defined contribution plans all result in progressively lower value and income replacement at retirement age when compared to the current defined benefit plan. However, according to PwC, these alternative plans would still provide close to or above the recommended 80 percent income replacement when they are paired with Social Security. Additionally, the combination, cash balance, and defined contribution plans result in slightly higher and more portable balances in the early years of an employee's career. Table 30 shows that, of the three alternatives, the combination plan would be most likely to allow employees to retire with a reasonable level of retirement income, while still lowering employer costs and future financial risk.

Table 30: Projected Impact of Options to More Aggressively Change Plan Design – Regular VRS Employees

Option	State Employees Affected	Purposes			Cost and Complexity		
		Recruit	*Retain*	*Retire*	*Admin Burden*	*Reduction in Employer Contributions After 40 Years (As % of Future Payroll)*	*Future $ Risk Level*
Create combination plan (R5)	Newly-hired and non-vested VRS	↔	↔	↔	High	1.94%	Lower
Create cash balance plan (R6)	Newly-hired and non-vested VRS	↔	↔	↓	Medium	3.33	Lower
Create defined contribution plan (R7)	Newly-hired and non-vested VRS	↔	↔	↓	Medium	4.94	Lower

Legend for Impact of Option on Purpose	↑ Beneficial	↔ Minimal	↓ Harmful

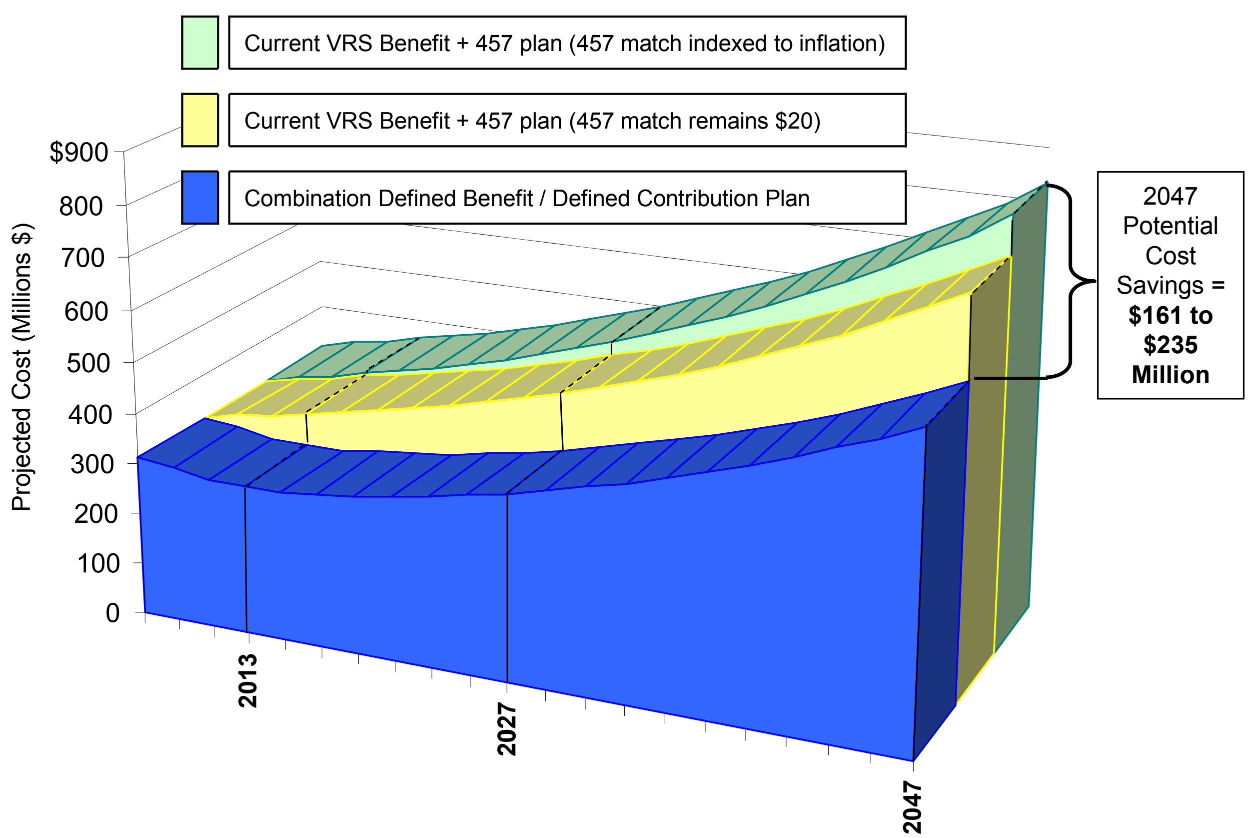
Note: The resulting reduction in State contributions to the retirement plan as a percent of payroll would be applied to the payroll comprising all State employees who are VRS members, with the exception of SPORS and VaLORS members.

Source: JLARC staff and PricewaterhouseCoopers analysis, 2008.

Importantly, the reduction in annual costs shown in Table 30 does not fully materialize until the last active employee in the current plan retires and all active employees are covered by the new plan. To illustrate, PwC projected the rate at which employer contributions will decrease over a 40-year timeframe as a result of implementing a combination plan for classified State employees (Figure 18).

Eventual savings are projected to range from $161 to $235 million in 2047. However, in 2013, the State will save approximately one-third ($64 to $67 million) of the ultimate savings projected for 2047, and in 2027 it will save between 57 percent ($110 million) and 68 percent ($134 million) of the eventual savings. According to PwC, the ultimate reduction in employer contributions for the cash balance and defined contribution plans would also occur over a 40-year timeframe, with savings accrual patterns being similar to those shown in Figure 18.

Figure 18: PwC Projection of Timeframe for Reduced Employer Contributions as a Result of Implementing a Combination Retirement Plan for State Employees



Source: PricewaterhouseCoopers analysis, 2008.

Practically speaking, as demonstrated in the discussion of employees' salaries in Chapter 3, it is likely that a large number of employees will find it difficult to contribute the five percent of salary necessary to achieve the benefit amounts resulting from these illustrative plan designs. This is especially true of the approximately 1,500 employees currently earning below the self-sufficiency standard. In fact, of the nearly 6,000 classified employee survey respondents who reported that they do not participate in the 457 deferred compensation program, nearly half indicated that they could not afford to make contributions, even though the minimum contribution is $10 per pay period. This, in addition to employees' preference for salary over retirement benefits, suggests that many employees would not contribute to a combination, cash balance, or defined contribution retirement plan at a level sufficient to result in an adequate benefit.

Finally, these alternative plans that have lower income replacement will likely result in at least some employees working for a longer time than they would under the current defined benefit plan. The State would have to consider how this further "aging" of an already "aging" workforce would impact other benefit costs (especially health insurance) and whether it is consistent with the overall purpose of offering a retirement plan to its employees.

Applying Options to Teacher Plan and Political Subdivision Plans Could Further Reduce Future Financial Risk, Preserve Administrative Efficiencies

As with the options discussed in the previous section to more moderately control the growth of future financial risk, JLARC staff and PwC analyzed the impact of these more aggressive options on schoolteachers' retirement benefits. JLARC staff interviewed small groups of teachers and superintendents in four localities about their satisfaction with the current VRS defined benefit plan design and their preference for a hybrid or defined contribution plan alternative. Nearly all of the teachers interviewed expressed a strong preference for the current plan design over the alternatives. The teachers interviewed stated that the guaranteed nature of the defined benefit plan is critical to their ability to retire and predicted that they would be unable to accumulate other retirement savings.

PwC analyzed the income replacement provided by the current VRS defined benefit retirement plan for teachers and found that "the current VRS program provides retirement benefits that exceed the traditional targets for career employees." JLARC staff analysis of VRS data showed that teachers retiring with full VRS benefits since 2000 retired at an average age of 59. In addition, 89 percent of teachers retired prior to the normal retirement age of 65. These findings indicate that despite identical eligibility requirements, teachers are retiring earlier, on average, than State employees in the regular VRS plan. As with State employees, retirement benefit designs that shift financial and investment risk to teachers would yield lower retirement benefits and would likely result in teachers working longer than they do now. Still, when paired with Social Security, PwC's analysis indicates that each of these alternatives, as presented in this report, would provide adequate income replacement. As mentioned previously, these illustrative options assume that employees contribute five percent of their salary to their retirement and that their accounts will earn 7.5 percent interest.

Because the amount of State funding associated with the teacher retirement plan is substantial and to ensure that VRS administrative costs attributable to similar State and local plan designs continue to be low, JLARC staff asked PwC to calculate cost avoidances if the above options were also applied to the teacher plan.

As shown in Table 31, the above options would ultimately result in a considerably lower future employer contribution for teachers' benefits when measured as a percentage of future payroll. The defined contribution plan ultimately results in the greatest cost avoidance, followed by the cash balance plan and then the combination plan. Each of these plans results in a progressively greater reduction in the long-term financial risk associated with providing retirement benefits to teachers. However, as discussed previously, the reduction in employer costs shown in Table 31 will only materialize after the last active employee in the current plan retires

Table 31: Projected Impact of Options to Aggressively Reduce the Level of Future Financial Risk and Ensure That Purposes Continue to Be Achieved –Teachers

		Cost and Complexity		
Option	**Teachers Affected**	*Administrative Burden*	*Reduction in Employer Contributions After 40 Years (As % of Future Payroll)*	*Future $ Risk Level*
Create combination plan (R5)	Newly-hired and non-vested VRS-covered teachers	High	3.33%	Lower
Create cash balance plan (R6)	Newly-hired and non-vested VRS-covered teachers	Medium	4.00	Lower
Create defined contribution plan (R7)	Newly-hired and non-vested VRS-covered teachers	Medium	5.88	Lower

Note: Reduction in State required contributions will be 55 percent of the total reduction and will be based on the proportion of payroll for the teacher plan funded by the State for SOQ-funded instructional positions (59 percent in FY 2007).

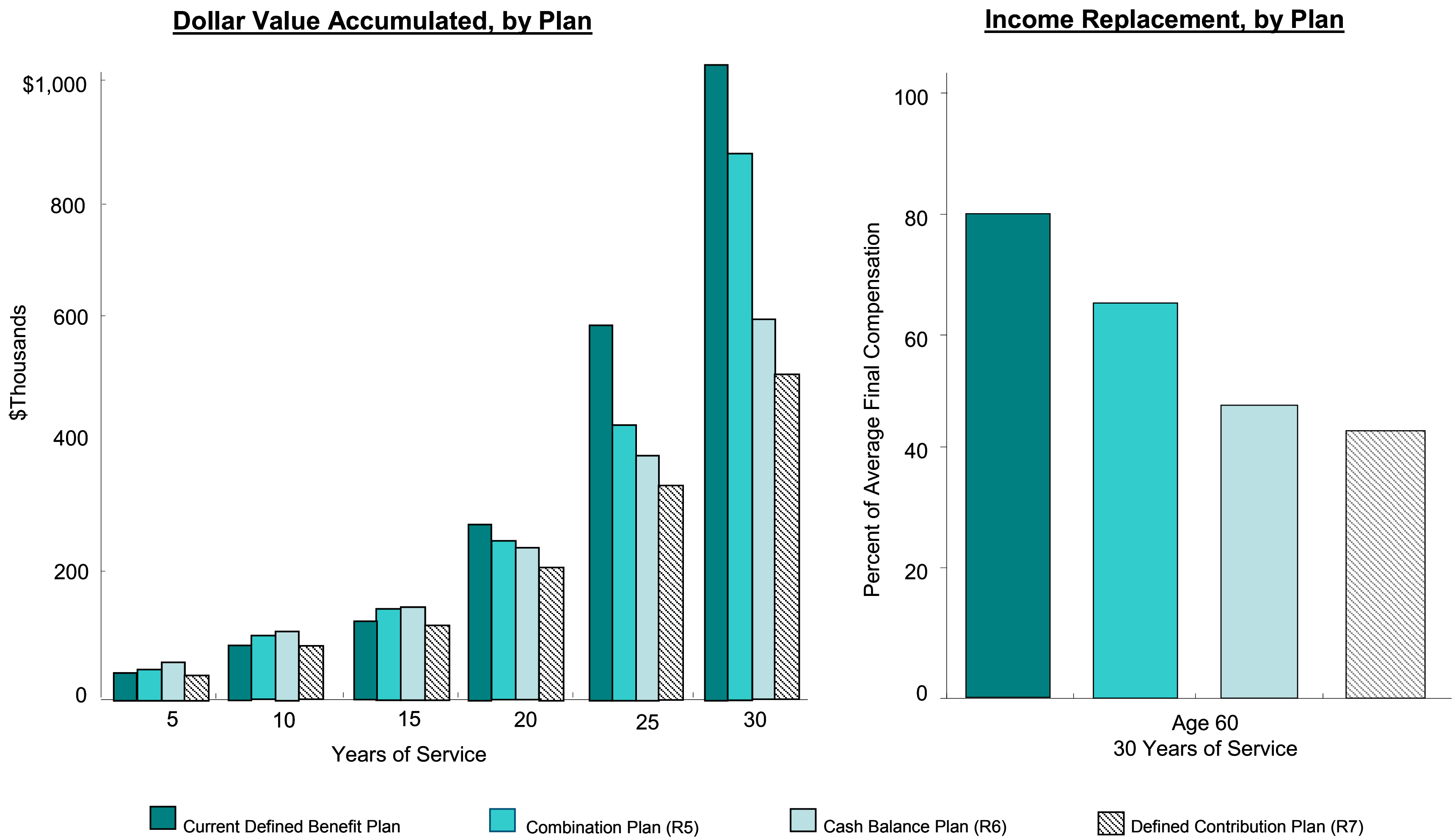
Source: JLARC staff and PricewaterhouseCoopers analysis, 2008.

and all active employees are covered by the new plan, which PwC has estimated will occur in 40 years. Moreover, incremental savings achieved in the intervening years would be somewhat offset by increased administrative costs during the transition period, particularly if VRS were to manage each new defined contribution account in the teacher plan.

The amount of State savings from enrolling newly hired teachers into one of these alternative plans would depend on how the State reimburses localities for the costs of the new plan. To be consistent with current practice, the State would reimburse localities for 55 percent of the total plan costs for teachers recognized by the SOQ, which would include an employer match to the defined contribution component of the new plan that is not part of the current defined benefit plan design. Reimbursing localities for a portion of the employer match could increase State costs attributable to teachers in the first three to four years of implementation. However, these costs would be offset by the more near-term savings the State achieves by enrolling all newly hired State employees into the alternative plan. For the combination plan, the State's savings could be substantially greater by only reimbursing localities for the defined benefit portion of the plan, but this would represent a significant change in the underlying portion of locality costs the State pays for under the Standards of Quality.

PwC did not calculate the impact of these options if they were applied to the retirement plans of the more than 500 political subdivisions participating in VRS—this would require a separate actuarial analysis for each option and plan. However, applying any changes that are made to the retirement plans for State employees and teachers to political subdivisions that participate in VRS would further serve to preserve current administrative efficiencies. This would also result in reducing the costs and long-term financial risk associated with the current plan for political subdivision employers, nearly half of which are local governments. It should be noted that while there is no requirement that the State fully fund the contribution rates recommended by the VRS actuary, political subdivisions are required to fully fund their recommended contribution rates.

Figure 19: Alternative Plans Yield Lower Accumulated Value Near Retirement and Lower Income Replacement in Retirement



Note: PricewaterhouseCoopers calculated income replacement from current defined benefit plan using employee deferrals to 457 plan and employer match placed in 401(a) accounts.

Source: JLARC staff summary of PricewaterhouseCoopers analysis, 2008.

Chapter 6 Leave Benefits

In Summary

The State's leave benefits are effective recruitment and retention tools for most agencies, in part because they are comparable to what other large employers offer. Leave benefits are effective, in most cases, at fostering employee productivity, motivation and morale, and work/life balance. However, the need for some agencies to be adequately staffed on a 24/7 basis places these agencies' needs for productivity at odds with employees' needs for work/life balance. In addition, many employees expressed a preference for cash compensation relative to benefits such as leave. Based on these factors, JLARC staff and Mercer developed two options for consideration. The first would allow employees to choose whether to exchange one to three days of unused annual leave for cash. The second option would more closely align the leave amounts provided with employee preferences by providing more frequent, annual increases in the days of leave for employees with fewer than five years of service.

The study mandate directed JLARC staff to review the adequacy of benefits for State employees, as well as identify alternative benefits that could be provided. This chapter assesses the adequacy of leave and other benefits against the purposes of recruitment, retention, motivation and morale, health and productivity, and work/life balance. The chapter also identifies potential options to change the State's approach to leave that would increase employee choice and better align leave provided with employee preferences.

LEAVE BENEFITS ARE EFFECTIVE TOOLS FOR RECRUITMENT AND RETENTION AND COMPETITIVE WITH OTHER EMPLOYERS

As noted in Chapter 1, the State provides a leave package that includes annual leave, paid holidays, and community service leave, and sick leave, family and personal leave, and disability benefits through the Virginia Sickness and Disability Program (VSDP). Other types of leave are available to employees in specific circumstances, such as military or educational leave. In total, employees have access to nine types of paid leave, as well as unpaid family and medical leave.

Leave Benefits Are Important Recruitment and Retention Tool for Most Agencies and Employees

On the JLARC staff survey, 72 percent of agencies agreed the State's leave benefits are an effective recruitment and retention tool for employees who are single or have few years of service. Eighty-six percent agreed that leave helped recruit and retain employees with more years of service or who have families. Employees also generally concurred, citing leave benefits among the top five reasons they work for the State. In particular, leave appears to have played a more significant role in recruiting younger employees and those with lower salaries. In terms of retention, employees with more years of service were more likely to report that leave played a significant role in their decision to continue working for the State.

State's Leave Benefits Are Comparable to Those of Other Large Employers

The effectiveness of leave benefits as a recruitment and retention tool depends in part on their value relative to what other employers offer. Mercer compared the value of Virginia's leave benefits to the leave provided by seven nearby states and 16 large peer employers. Mercer valued Virginia's leave benefits ninth when compared to the 16 large peer employers and third when compared to the seven nearby states. These two rankings suggest that Virginia's overall leave package is in a range comparable to what other large employers provide.

Within the total amount of leave provided, the State provides slightly more holidays but less sick leave than other employers. For example, while the number of paid holidays in Virginia (12 per year), is similar to the number provided by other state governments (11.3 per year), it is more than the federal government (ten per year) and Virginia's large employer peer group (median of ten per year). By contrast, while VSDP participants receive eight to ten days of sick leave per year, the seven peer states, the federal government, and Virginia's large employer peer group provide 12 or more days of sick leave. While the majority of peer organizations allow sick leave to carry over, Virginia does not because sick leave is part of the VSDP, which provides disability benefits for longer absences. Only 23 to 35 percent of public and 31 to 39 percent of private sector employees have access to similar disability programs.

Annual leave is the largest single category of leave the State provides its employees, and it is competitive with other large employers. As shown in Table 32, the State grants annual leave that is similar to the other nearby states and its large employer peer group. Virginia grants more annual leave to employees with higher years of service when compared to all large private employers. However, Virginia grants fewer days of annual leave than the federal government for all employees except those with 25 or more years of service. Overall, when compared to large peer employers

Table 32: Virginia's Annual Leave Is Similar to Other Employers

Employer	Days of Annual Leave Granted, by Years of Service					
	1	*5*	*10*	*15*	*20*	*25 +*
Virginia	12	15	18	21	24	27
Federal government	13	20	20	26	26	26
Nearby states	12	17	20	21	24	24
Large employer peer group	10	16	20	20	25	26
Private employers with 100 or more workers	10	15	18	20	21	22

Source: Bureau of Labor Statistics National Compensation Survey: Benefits in Private Industry, 2007; Workplace Economics 2006 State Employee Benefits Survey, U.S. Office of Personnel Management, and Mercer, 2008.

and nearby states, Mercer valued Virginia's annual leave twelfth out of 14 and sixth out of eight, respectively.

LEAVE AND OTHER BENEFITS FOSTER PRODUCTIVITY, MORALE, AND WORK/LIFE BALANCE

While leave benefits play an important role in recruitment and retention, their primary purpose is providing employees with a work/life balance, which fosters long-term productivity and employee motivation and morale. The leave benefits work most effectively to meet the needs of employees and agencies when (1) employees are able to utilize their leave as needed to balance work and personal demands, and (2) employee absences do not have a deleterious effect on agency productivity. Other benefits, such as flexible work schedules and telecommuting, are also approaches that allow employees to maintain an appropriate work/life balance.

Leave Benefits Are Key to Employee Morale and Work/Life Balance and Do Not Hinder Productivity at Most Agencies

Three-quarters of agencies agreed that leave was an important tool to keep morale and productivity high, and 79 percent of employees agreed that leave was important for their morale and productivity. In fact, when compared to other organizations, Mercer found that State employees rated their work/life balance better than employees at other types of employers. Roughly three-quarters of employees agreed their leave was reasonable to help them balance their work/ life demands and provided sufficient choice and flexibility.

More than 80 percent of employees also agreed they could generally utilize the leave provided to them (eight percent disagreed and eight percent neither agreed nor disagreed). According to DHRM, in 2007 employees used an average of 13 days of annual leave, five sick days, and three VSDP family and personal days. Most agencies did not report that this level of leave utilization by their employees hindered agency productivity.

DOC and DMHMRSAS Report Leave Hinders Productivity, 24/7 Employees Less Able to Use Leave and Less Satisfied

Despite statewide agreement that leave benefits are achieving their purposes, certain agencies and employee groups tend to view these benefits less favorably. For instance, over a third of DOC and roughly half of DMHMRSAS facilities reported the leave structure reduced agency productivity. In fact, five of the eight agencies that strongly agreed that leave reduces productivity were DMHMRSAS or DOC facilities. In these facilities that operate 24 hours a day, seven days a week (24/7), maintaining certain staffing levels during all shifts is critical, and employee absences, especially when unplanned, can disrupt agency operations. Perhaps because of this tension between agency and employee interests, DMHMRSAS and DOC employees were least satisfied with their work/life balance. More broadly, State employees who work evening, night, or rotating shifts were less likely than other employees to agree they can utilize their leave or that the leave structure offers sufficient choice and flexibility. These employees were also less satisfied overall with their leave benefits and work/life balance.

Other Benefits and Flexibilities to Facilitate Work/Life Balance Are Available Though in Certain Cases Are Not Widely Used

As noted in Chapter 1, the State also offers employees a number of other opportunities to balance their work/life demands, such as working part-time, working alternative or compressed schedules (such as four-day work-weeks), or telecommuting. These benefits are also offered by most state governments, but less than half of all other employers. Despite the availability of these flexibilities, a relatively low percentage of eligible employees actually utilize them. Although the *Code of Virginia* requires each agency to have a goal of "not less than 20 percent of its eligible workforce telecommuting" by 2010, less than 13 percent of eligible employees currently telecommute (less than four percent of all classified employees). In addition, nearly 40 percent of the employees who are eligible to work alternative schedules do not. Consequently, there is likely room to use the existing benefits and flexibilities to a greater extent before considering implementing additional flexibilities.

These types of flexibilities do appear to enhance employee satisfaction and productivity. Over 80 percent of agencies reported that flexible work schedules were important for them to maintain a stable and productive workforce, and roughly 60 percent reported that telecommuting and compressed work-weeks were important for this purpose. In fact, according to a MetLife survey of employers, "providing employees with benefits designed to better balance their work and personal lives" was their top benefits strategy in 2007. About two-thirds of State employees were either somewhat or very interested in telecommuting and flexible or part-time work schedules. An increased emphasis on these types of benefits is consistent with the notion that workers want greater choice and flexibility in determining when and where they work, as noted in Chapter 2.

Long-Term Leave Liability

As of June 30, 2007, the liability for accrued leave for all leave-eligible State employees (which includes more than just classified employees) was approximately $570 million, according to the Commonwealth's Comprehensive Annual Financial Report. This is the amount the State would have to pay if all employees with accrued balances left State service at the same time. According to DHRM staff, this is largely an unfunded liability, and it could be challenging for agencies, particularly those with many long-tenured employees, to pay for these leave balances if too many employees terminate or retire at the same time.

MODERATE OPTIONS TO ENHANCE THE STATE'S APPROACH TO LEAVE BENEFITS

As shown in Table 33, the State's leave benefits are most effective at achieving the purposes of recruiting and retaining employees. For most agencies, leave benefits also encourage employee morale and productivity and facilitate an adequate work/life balance. To a certain degree, however, the leave structure appears to place the staffing needs of 24/7 agencies at odds with employee morale and work/life balance. Because of this issue, JLARC staff believe the goals of facilitating agency productivity as well as employee morale and work/life balance are being partially achieved statewide. State spending associated with leave, which is primarily payouts to employees for their leave balances when they leave State service or retire, was less than 0.5 percent of total compensation spending in FY 2007 ($24 million). Although the amount paid out each year will likely increase as more employees retire and are paid cash for their accrued leave balances, broadly speaking the future cost risk related to leave is relatively low.

Based on the above assessment, it appears that no major changes to the leave programs are warranted when measured against the purposes of compensation. However, JLARC staff have developed two options that the General Assembly could consider to offer employees the ability to choose cash instead of leave and to better align the leave structure with employee preferences, as discussed in Chapter 2. The first option would provide all employees with increased choice, while also potentially balancing the, at times, com-

Table 33: Summary Assessment of Current Approach to Leave Benefits

	Purpose					Cost	
	Recruit	*Retain*	*Motivation & Morale*	*Health & Productivity*	*Work / Life Balance*	*Current $*	*Future $ Risk Level*
Leave Benefits	●	●	◐	◐	◐	$24 Million	Low

Legend for Scale of Purpose Achieved | ● Mostly | ◐ Partially | ○ Minimally

Source: JLARC staff assessment, 2008.

peting goals of agency productivity and employee work/life balance in 24/7 work environments. The second option could potentially help the State retain employees during their first five years of service by providing more frequent annual increases in the days of annual leave granted.

Option L1: Allow Employees to Exchange Portion of Unused Annual Leave for Cash Each Year

Currently, the State allows employees to receive cash for up to 42 days of unused annual leave when they terminate their employment or retire. However, 90 percent of agencies expressed interest in providing cash to employees for unused leave at the end of each year. In addition, Mercer's analysis of employee survey responses found that the average employee rates salary nearly ten times more important than annual leave and holidays. These two findings led JLARC staff and Mercer to develop an option under which employees could choose to exchange part of their unused annual leave at the end of the year for cash.

Allowing employees to exchange unused leave at the end of the year for cash may be particularly appealing to DMHMRSAS and DOC facilities that expressed concern about the effect of the leave structure on productivity. It may also be appealing to DOC and DMHMRSAS employees (and others who work alternative schedules) who reported being less able to utilize their leave than other employees. In fact, DOC and DMHMRSAS agencies were more likely than other agencies to be very interested in providing cash to employees for unused leave. Employees who have the incentive for additional cash may use fewer days of leave, thereby reducing the tension between agency staffing needs and employee requests for time off.

Under this option, employees would still be subject to existing provisions, such as the maximum leave payout associated with their tenure, (Table 34). This amount would be reduced as an employee

Table 34: Annual Leave Accrual Rates, Maximum Leave Carryover, and Maximum Leave Payout

Years of Service	Days Accrued Per Year	Maximum Carryover Days	Maximum Payout Days
Less than 5	12	24	24
5	15	30	30
10	18	36	36
15	21	42	36
20	24	48	42
25	27	54	42

Source: Department of Human Resource Management Policy.

sells days of leave during her or his career. Employees would also be required to maintain a reserve leave balance (for example, five days) after exchanging the unused leave to cover future absences. Finally, employees would not be able to sell and carry forward more than the maximum carryover balance each year. For instance, an employee with less than five years of service (with a maximum carryover of 24 days) who wishes to sell a day of leave could only carry over 23 days of leave that year.

If established within the existing provisions for maximum carryover and payout, this option is largely cost neutral over the long term. Agencies are supposed to account for the potential liability associated with employee leave payouts at termination or retirement. Therefore, to the extent that employees exchange leave for cash during their career, these long-term liabilities—the amount the agency would pay at termination or retirement—would be incrementally reduced during an employee's career. For example, if an employee sold three days a year (option L1.c in Table 35) and did not exceed the maximum leave payout based on her or his years of service, the State's long-term liability for the employee's leave payout would have been reduced by 86 percent after her or his first 12 years of service. This change is consistent with employer trends to reduce long-term liabilities for other benefits such as retiree health care.

This option, however, would require a one-time increase in agencies' base budgets to ensure sufficient funds are available at the end of the year when employees would make the exchange. Table 35 illustrates the potential cost impact of this shift from long-term liabilities to near-term funding. The table illustrates this cost impact for three scenarios, allowing employees to sell either one, two, or three days of unused annual leave per year. There would also be

Table 35: Estimated Costs If Classified Employees Sell One, Two, or Three Days of Unused Annual Leave

Option	Estimated Cost ($ millions)
Employees sell one day of leave (L1.a)	$9.0
Employees sell up to two days of leave (L1.b)	17.8
Employees sell up to three days of leave (L1.c)	26.1

Notes: Estimates based on assumption that employees are eligible to sell leave if they retain a balance of five days of unused annual leave after selling one, two, or three days. Estimates also assume that all eligible employees would sell one, two, or three days of leave, which would represent the upper-bound of potential costs. Cost is based on weighted average salaries for classified employees. Costs were inflated to better represent costs for the entire classified workforce, not just employees whose leave records are in the Commonwealth Integrated Payroll and Personnel System.

Source: DHRM estimation of CIPPS leave balances on January 9, 2008, and weighted averages of employee salaries as of January 1, 2008.

administrative costs associated with tracking the cumulative leave sold by each employee and integrating this provision into the State payroll system.

Irrespective of how many days of leave employees would be allowed to exchange for cash, this option would allow employees to have some degree of choice in the proportions of the compensation they receive. Employees could choose to sell none of their leave, while those who do not use all their allotted leave each year or value cash more heavily could exercise this option. As shown in Table 36, providing employees with this choice makes it likely that this option would have a beneficial impact on employee morale and a minimal, but positive, impact on agency recruitment and retention. The State's relatively low level of future financial risk associated with leave (which is difficult to fully quantify) would be further lowered because employees who take advantage of this option would reduce what the State would pay for their leave balances when they retire or terminate employment.

Table 36: Summary Assessment of Potential Impact of Option L1

	Purpose					Cost	
	Recruit	*Retain*	*Motivation & Morale*	*Health & Productivity*	*Work / Life Balance*	*Projected Cost*	*Future $ Risk Level*
Exchange Unused Annual Leave for Cash (L1)	↔	↔	↑	↑	↔	$9 to $26 million	Lower

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful

Source: JLARC staff assessment, 2008.

Option L2: Redistribute Leave to Match Employee Preferences and Compensate Employees for Leave That Does Not Carry Over

In 2007, 70 percent of total State turnover was among employees with less than five years of service. Although lack of leave is not the reason for this turnover, as discussed in Chapter 2, employees with less than five years of service placed greater importance on leave than did those with more experience. In fact, employees' preferences for leave appear to have an inverse relationship with the proportions of leave the State allocates. While annual leave accruals increase with years of service, employees with the fewest years of service place the highest value on annual leave, according to Mercer's assessment (relative to other elements of compensation). These findings suggest that the State could provide a slight increase in the annual leave allocated to employees during the early years of their tenure to better align employee preferences for leave with amounts provided by the State.

Rather than waiting until an employee's fifth year of service to increase their annual leave from 12 to 15 days, more frequent increases could be granted. Employees with two years of service could receive 13 days and those with four years of service could receive 14 days. Employees with five years of service would still receive 15 days. Such an approach could serve as an additional (though comparatively minor) reason for employees to continue to work for the State during the first five years of their tenure when they are most likely to leave.

Previous Increases in Annual Leave Days

In 2000, the State increased the days of annual leave granted to employees with 15 or more years of service. Annual leave was increased from 18 to 21 days after 15 years of service, from 21 to 24 days after 20 years, and from 21 to 27 days after 25 years.

Increasing the amount of leave provided to the workforce in total, however, does not appear warranted and could potentially hinder agency productivity. To neutralize the productivity impact of such a change, the maximum amount of annual leave that more experienced employees accrue could be slightly reduced. As shown earlier in this chapter, the 27 days the State provides is more than what other nearby states, large peer employers, and large private employers grant employees with more than 25 years of service. To offset the increase in annual leave for those with less than five years of service, the 27 days of leave provided to those with 25 or more years of service could be scaled back to 24 days.

This minor reduction in annual leave could be made more palatable to employees with 25 or more years of service by applying a concept similar to that identified in option L1 above. Each year, employees may carry over a portion of their unused leave for future use or payout (Table 34). However, employees may lose a portion of their unused leave each year if their unused balance exceeds the maximum amount they are allowed to carry over. The State could compensate employees for up to ten percent of the value of this unused leave (which would be lost). Although this option would apply to all employees, those with the highest years of service tend to lose the most leave and could therefore benefit the most from this provision. For example, in 2007, employees lost an average of three hours of annual leave, but those with 25 or more years of service lost an average of nine hours. Because the aggregate amount of leave which is lost each year is relatively small, DHRM estimates that compensating all employees for ten percent of their lost leave would cost approximately $0.6 million per year.

The maximum carryover amounts just described correspond to annual accrual levels based on years of service (Table 34). If the State scales back the accrual rate for employees with 25 or more years of service, it could also reduce the maximum leave carryover from 54 to 48 days to correspond with the new accrual level. If this change is made, and employees are paid ten percent of their excess leave at year-end, this approach would require an additional one-time amount of $0.6 million. The lower carryover level could reduce future absences or payout amounts for this group of employees.

As shown in Table 37, redistributing leave to better match employee preferences could have some beneficial impact on retention among employees with five years of service or less. Because this increase would be offset by slightly reducing the maximum amount of leave for more experienced employees (and because employees in certain cases do not use all the leave allocated to them in a given year) this option would have a minimal impact on agency productivity and employee work/life balance. Any potential reduction in employee morale and motivation for the approximately 11,000 employees who would have their leave reduced from 27 to 24 days could be offset by compensating them each year for a portion of leave they would otherwise lose. This compensation would not materially affect the low level future cost risk associated with the current leave benefits.

Table 37: Summary Assessment of Potential Impact of Option L2

	Purpose					Cost	
	Recruit	*Retain*	*Motivation & Morale*	*Health & Productivity*	*Work / Life Balance*	*Projected Cost*	*Future $ Risk Level*
Redistribute leave to match employee preferences (L2)	↔	↑	↔	↔	↔	$0.6 to $1.2 million	Maintained

Legend for Impact of Option on Purpose	↑ Beneficial	↔ Minimal	↓ Harmful

Source: JLARC staff assessment, 2008.

AGGRESSIVE OPTIONS TO CHANGE LEAVE BENEFITS DO NOT APPEAR WARRANTED

A more aggressive modification of the existing leave system would be the adoption of a paid-time-off (PTO) bank of consolidated leave, an approach which is used by about a third of all employers and about one-fifth of all governments. A PTO approach consolidates separate categories of paid leave into a single bank which can be used by employees for any purpose. The amount of leave provided and provisions for carryover and payout vary by employer. JLARC staff and Mercer examined the potential use of PTO for State employees, and Mercer included a PTO option in its suggested alternatives.

After careful consideration, however, it does not appear that a change to the PTO approach is warranted at this time. Although a PTO structure offers several benefits, including employee flexibility and administrative simplicity, JLARC staff analysis found no compelling justification for such an option. Agencies and employees uniformly rated the leave system positively, and it contributes well to agencies' ability to recruit and retain employees. Only eight percent of employees disagreed that the existing leave structure provides them sufficient choice and flexibility. Although the majority of agencies expressed interest in combining several categories of leave, few were interested in reducing the overall amount of leave provided. Typically, however, when leave categories are consolidated through a PTO, the aggregate amount is reduced because employees can use the leave for any purpose. Finally, according to Mercer though employers can adopt a PTO to reduce unscheduled absences, Virginia already utilizes VSDP to help manage unscheduled absences due to illness, injury, and disability.

In addition, transitioning from the current approach to a PTO would also present a significant administrative challenge. Specifically, because one the primary objectives of a PTO is administrative simplification, all employees, both current and prospective, would have to participate in the PTO system to prevent the State from administering multiple leave systems. Implementing a PTO for new hires would likely increase administrative complexity because the State would be maintaining three separate leave systems: the two current systems (VSDP for about 80 percent of employees and the traditional sick leave program for the remainder) and the new PTO leave system for new hires.

Nevertheless, establishing a PTO with provisions that prohibit or limit the amount of leave which may be paid out or carried over could reduce the State's long-term financial liability associated with leave balances. As indicated earlier, the State has a liability to pay for employees' unused leave balances when they terminate employment or retire. If the PTO rules prohibit employees from carrying over large leave balances, this long-term liability could be reduced.

Another alternative suggested by Mercer would involve reducing the number of paid holidays provided to employees. As indicated earlier, the number of State holidays is similar to other public employers, but more generous than private industry. Virginia could eliminate the two non-federal holidays, Lee-Jackson Day and the day after Thanksgiving. The reduction of two holidays would not result in any direct savings except for those agencies that pay overtime to cover 24/7 shifts, but could result in an increase in productivity since some portion of the State workforce would be on the job two additional days each year.

Although this reduction could be justified based on a comparison with other employers, the change would not help agencies recruit and retain workers. Furthermore, as indicated earlier, Mercer found the State's total leave package to be comparable to other employers. In addition, according to the JLARC staff survey, only two agencies strongly agreed that the number of State holidays inhibits their ability to do their work and/or provide services to customers. Mercer also indicated that “any reduction of holidays, however warranted, will be viewed as a take away by employees.” This option could potentially be more amenable to employees if the State provided “floating” holidays that could be used by employees at any point during the year.

Chapter 7

Total Compensation Options

In Summary

The overall assessment of the State's current approach to salaries and benefits shows that the purposes of total compensation are being either mostly or partially achieved. The current approach will, however, result in the agencies that are struggling to build and maintain an adequate workforce continuing to have difficulty. Not adjusting the health insurance and benefit programs will likely result in increased cost pressures in future years. In accordance with the study mandate, JLARC staff have identified two total compensation options for further consideration by the General Assembly. Both options involve altering the benefits provided to employees and redeploying some portion of the cost avoidance towards increased cash compensation for selected employees. In the fifth year of implementation, the first option would result in approximately $82 million in cost avoidance. The second option would result in approximately $1 million in cost avoidance in the fifth year, but is designed to achieve greater savings in the long-term.

The mandate for this study directed JLARC staff to make recommendations for the compensation of employees of the Commonwealth that promote the purposes of compensation, while addressing long-term costs. Accordingly, this chapter identifies two total compensation options for consideration by the General Assembly that are designed to better achieve the purposes of total compensation and reduce the State's financial risk.

CURRENT APPROACH WILL RESULT IN CERTAIN AGENCIES CONTINUING TO STRUGGLE AND FUTURE BENEFIT COST RISK

As shown in Table 38, the JLARC staff summary assessment of the State's approach to salaries and benefits yields no instances in which the purposes of compensation are not at least partially achieved. Consequently, the General Assembly could continue the current approach to compensation. According to Mercer, Virginia's approach includes

> [A] heavy emphasis on benefits and retirement that appear to be geared to retain the current, already long-tenured employees (or possibly attract prospective employees looking for a long-term career opportunity with good work / life balance). This is likely to be less effective for attracting early-in-career talent interested in a shorter term employment opportunity.

Table 38: Summary Assessment of State's Current Approach to Salaries and Benefits

	Purposes						Cost	
	Recruit	*Retain*	*Motivation & Morale*	*Health & Productivity*	*Retire*	*Work/ Life Bal-ance*	*Current $ (millions)*	*Future $ Risk Level*
Salary	◐	◐	◐				$3,301	Low
Health Insurance	●	●		◐			677	High
Retirement Benefits	●	●			●		487	Medium
Leave Benefits	●	●	◐	◐		◐	24	Low

Legend for Scale of Purpose Achieved | ● Mostly | ◐ Partially | ○ Minimally | [Blank] Not Applicable

Note: Purpose assessment shown only if element of total compensation was noted as playing a major role in achieving the purpose in Table 1, Chapter 1.

Source: JLARC staff assessment.

If no changes are made, current and prospective employees will continue to view job stability and competitive benefits as the State's primary recruiting and retention tools. However, the challenges that certain agencies are facing in managing the State's workforce will likely worsen. In the near term, agencies experiencing recruiting and retention challenges (in particular, DOC and DMHMRSAS facilities) attributable to salaries will continue to struggle and likely confront greater difficulty as their workforce ages and subsequently retires. Further, agencies that can recruit and retain sufficient staff will likely continue to be confronted with the fact that in many cases some of their employees prefer a greater emphasis on cash compensation.

The historical and projected rate of spending growth for health insurance . . . has prompted JLARC staff to designate it the highest financial risk area among compensation.

Another critical concern is the cost of health insurance. It is unclear how long the growth of State health insurance spending can be sustained. As noted in Chapter 4, most large employers are also grappling with how to address rising health costs. The State's approach of absorbing the majority of cost increases will eventually need to be addressed. The exact threshold for making changes is unclear, but the historical and projected rate of spending growth for health insurance, as well as the influence of factors outside the State's direct control, has prompted JLARC staff to designate it the highest financial risk area among compensation.

Finally, as noted in Chapter 5, there is a historical tendency for the contributions to the VRS retirement plan to be funded at less than the amount actuarially recommended. If this trend continues, the liabilities to pay for the retirement benefits promised to current employees will continue to be pushed onto future generations in the form of higher State contributions, or will have to be offset by higher than assumed investment returns.

TOTAL COMPENSATION OPTIONS FOR FURTHER CONSIDERATION BY THE GENERAL ASSEMBLY

This report has made recommendations and identified potential options to change the State's approach to salaries, health insurance, retirement benefits, and leave benefits for classified employees. Due to the comprehensive nature of this review, and in accordance with the study mandate, JLARC staff have identified two total compensation options for further consideration by the General Assembly. These total compensation options were identified considering three criteria:

1. Would the option better achieve the purposes of salaries and benefits or not unnecessarily harm the State's ability to achieve its purposes?
2. Would the option improve the sustainability of benefit programs, reduce the level of future financial risk confronting the State, and/or not lead to inefficient expenditures?
3. Would the option increase employee choice and/or better align salaries and benefits with employee preferences?

Based on these three criteria, the most aggressive options identified in the previous chapters have not been included in the two total compensation options that follow. The total compensation options presented below, however, still represent substantial changes to the current approach and will therefore need to be carefully evaluated prior to implementation. For example, the VRS actuary will need to determine the likely impact of any specific proposal to modify employee contributions, the retirement age, or the cost of living adjustment. And of course, a specific proposal to implement targeted salary adjustments will also affect the assumptions used to calculate the VRS employer contribution rates. Implementing salary, retirement, health insurance, and other changes simultaneously will likely result in complex interactions that should be identified and understood prior to implementation.

Total Compensation Option 1 – Targeted Salary Increases, Moderate Health and Retirement Changes, and Increased Employee Choice

Total compensation option 1 largely centers around adjusting the proportions of total compensation spending to place a slightly higher emphasis on cash compensation and a slightly lower emphasis on benefits. This is accomplished through option components with the objectives of improving recruitment, retention, and motivation in targeted instances, lowering State costs and reducing State financial risk for health insurance and retirement benefits, and increasing employee choice.

The components of total compensation option 1 and their projected impact on the State's purposes and costs are summarized in Table 39. Each of the option components would have either a minimal or beneficial impact on the State's ability to achieve the purposes of salaries and benefits. This is primarily because the moderate op-

Table 39: Summary Assessment of Potential Impact of Total Compensation Option 1

Option Component	Option Objective	Purposes						Cost		
		Recruit	*Retain*	*Motivation & Morale*	*Health & Productivity*	*Retire*	*Work / Life Balance*	*Projected Annual Cost Impact in Year 5*		*Future $ Risk Level*
								State, SPORS, VaLORS	*Teacher*	
Moderate pay for purpose (S1)	Improve recruitment and retention	↑	↑	↔				+$89 million		Higher
Moderate changes to reduce growth of State health spending (H1)	Improve sustainability of health benefits	↔	↔		↔			-$46 million		Lower
Employee contributions into VRS (R1)	Improve sustainability of current level of retirement benefits	↔	↔			↔		-$91 million	-$42 million	Lower
Reduced COLA (R2)		↔	↔			↔		-$55 million	-$29 million	
Increase minimum retirement age for new hires and non-vested VRS employees (R3)		↔	↔			↔		TBD based on future hiring		
Exchange unused leave for cash (L1.b)	Increase employee choice	↔	↔	↑	↑		↔	+$21 million		Lower
Projected Total Cost Impact in Year 5 - State Employees Only								**-$82 million**		
Projected Total Cost Impact in Year 5 - Teacher Retirement								**-$71 million (State SOQ)** **-$180 million (Local)**		

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful | [Blank] Not Applicable

Notes: Annual cost impact figures were derived making various assumptions about the future rate of payroll growth, including performance increases of two percent in FYs 2009 and 2010, three percent in subsequent fiscal years, and a two percent additional increase to fund option S1 in FY 2010. Interaction effect between salary option and retirement options could lead to a $2 million reduction in total cost avoidance shown. Cost impact for health and retirement benefits include all plan members, not just classified employees. No changes to teacher payroll were assumed. Local cost avoidance for teacher retirement includes non-SOQ staff.

Source: JLARC staff assessment.

tions for health insurance and retirement discussed in Chapters 4 and 5 have been combined with the option for moderate implementation of the pay for purpose approach, and the option to increase employee choice by exchanging two days of unused annual leave for additional cash.

The changes to health insurance and retirement would still result in the State offering a competitive benefits package, and would have a minimal—though negative—impact on recruiting and retention. This minimal negative impact would then be offset by targeted salary increases based on the goals of improving recruitment, retention, and motivation where necessary. Importantly, reducing the role that health insurance and retirement benefits play in retaining the workforce without some measure of targeted increases in salaries will likely increase statewide turnover—and push agencies with above average turnover into further difficulty building a workforce. Collectively, these option components would, by the fifth year of implementation, result in approximately $82 million of cost avoidance. Lower incremental cost avoidances will occur prior to that point, but will be determined by the exact implementation timeframe used. All options except for the targeted salary increases lower the future financial risk that confronts the State.

Finally, Table 39 also shows that if the options to improve sustainability of the current level of retirement benefits are applied to the teachers' retirement plan also administered by VRS, there would be an additional $71 million of cost avoidance for the State in year five and approximately $180 million in cost avoidances for local school divisions.

Total Compensation Option 2 – Targeted Salary Increases, Moderate Health Changes, Alternative Retirement Plan Designs, and Increased Employee Choice

Total compensation option 2 includes more substantial changes to the structure of the retirement system: a combination retirement plan for regular VRS members and integral part trust (IPT). These changes would apply only to employees not yet vested in VRS and to all newly-hired employees. Therefore, the full fiscal impact of these changes will be realized less immediately than retirement changes included in total compensation option 1 that would apply to the current workforce.

The components of total compensation option 2 and their projected impact on the State's purposes and costs are summarized in Table 40. As with total compensation option 1, each of the components would have either a minimal or beneficial impact on the State's ability to achieve the purposes of salaries and benefits.

Table 40: Summary Assessment of Potential Impact of Total Compensation Option 2

<table>
<tr><th rowspan="2">Option Component</th><th rowspan="2">Option Objective</th><th colspan="6">Purposes</th><th colspan="3">Cost</th></tr>
<tr><th>Recruit</th><th>Retain</th><th>Motivation & Morale</th><th>Health & Productivity</th><th>Retire</th><th>Work / Life Balance</th><th colspan="2">Projected Annual Cost Impact in Year 5</th><th>Future $ Risk Level</th></tr>
<tr><td>Moderate pay for purpose (S1)</td><td>Targeted salary increases based on business case</td><td>↑</td><td>↑</td><td>↔</td><td></td><td></td><td></td><td colspan="2">+$90 million</td><td>Higher</td></tr>
<tr><td>Moderate changes to reduce growth of State health spending (H1)</td><td>Improve sustainability of health benefits</td><td>↔</td><td>↔</td><td></td><td>↔</td><td></td><td></td><td colspan="2">-$46 million</td><td>Lower</td></tr>
<tr><td>Create new combination plan (R5)</td><td rowspan="2">Reduce long-term financial risk and increase employee choice</td><td>↔</td><td>↔</td><td></td><td></td><td>↔</td><td></td><td>State
-$66 million</td><td>Teacher
-$22 million</td><td rowspan="2">Lower</td></tr>
<tr><td>Integral Part Trust (R4)</td><td>↔</td><td>↔</td><td></td><td></td><td>↔</td><td></td><td colspan="2"></td></tr>
<tr><td>Exchange unused leave for cash (L1.b)</td><td>Increase employee choice</td><td>↔</td><td>↔</td><td>↑</td><td>↑</td><td></td><td>↔</td><td colspan="2">+$21 million</td><td>Lower</td></tr>
<tr><td colspan="8">Projected Total Cost Impact in Year 5 - State Employees Only</td><td colspan="3">-$1 million</td></tr>
<tr><td colspan="8">Projected Total Cost Impact in Year 5 - Teacher Retirement</td><td colspan="3">-$22 million (State SOQ)
-$150 million (Local)</td></tr>
</table>

Legend for Impact of Option on Purpose | ↑ Beneficial | ↔ Minimal | ↓ Harmful | [Blank] Not Applicable

Notes: Annual cost impact figures were derived making various assumptions about the future rate of payroll growth, including performance increases of two percent in FYs 2009 and 2010, three percent in subsequent fiscal years, and a two percent additional increase to fund option S1 in FY 2010. Interaction effect between salary option and retirement options could lead to a $1 million reduction in total cost avoidance shown. Cost impact for health and retirement benefits include all plan members, not just classified employees. No changes to teacher payroll were assumed. Local cost avoidance for teacher retirement includes non-SOQ staff.

Source: JLARC staff assessment.

As noted in Chapter 5, of the three alternative retirement plans illustrated by JLARC staff and PwC, the combination retirement plan would be the most likely to still allow employees to retire with a reasonable level of retirement income, while also lowering the State's costs and future financial risk. Creating a new combination retirement plan for all non-vested and newly-hired employees would have a minimal impact on the State's ability to recruit and retain employees. The defined contribution component of the combination plan would allow employees to build retirement savings in an account that they can either access when they leave the State's workforce (regardless of their age or years of service) or transfer to another employer's defined contribution plan. In return for this flexibility, however, employees would likely either (1) have less income during retirement and/or (2) need to work later in life than under the current defined benefit plan. In addition to the new benefit structure, the combination retirement plan would also have a higher minimum retirement age of 60. This change would reduce the State's level of future financial risk associated with retirement benefits because of the lower defined benefit portion that the State guarantees to retirees.

Placing non-vested and newly-hired employees in an IPT rather than the retiree health insurance credit would eventually be cost neutral for the State, but it would lower the State's long-term financial risk because it would no longer guarantee a credit during retirement. However, as noted in Chapter 5, there would be an administrative burden associated with the transition and the liability associated with the credit would be spread over an increasingly smaller number of employees.

Collectively, in the fifth year of implementation, these option components would result in approximately $1 million in cost avoidance. PwC projected that the combination retirement plan would eventually save 1.94 percent of payroll after 40 years. As noted in Chapter 5, savings from this plan would be less prior to year 40, but would gradually increase. For example, by 2027 the annual cost avoidance amounts to $110 million, and by 2047 the annual cost avoidance is projected to be as much as $161 million. Also as noted in Chapter 5, this cost avoidance would be reduced to some degree by the increased administrative costs of maintaining a second retirement system structure.

The combination plan could also be implemented for non-vested and newly-hired teachers. Placing all non-vested and newly-hired teachers into a combination plan would result in an ultimate cost avoidance of 3.33 percent of payroll. As with the State employee plan, PwC estimates that the cost avoidance would not fully materialize for 40 years and would be somewhat offset by increased administrative costs. In the fifth year of implementation, the cost avoidance from the combination plan if applied to the teachers would be approximately $22 million for the State and approximately $150 million for local school divisions.

List of Recommendations:
Review of State Employee Total Compensation

1. The General Assembly may wish to require the Department of Human Resource Management (DHRM), with assistance from the Virginia Retirement System, to prepare an annual statement of total compensation for each classified employee. The General Assembly may also wish to require independent, legislative, and judicial agencies, and institutions of higher education to prepare the annual statements for their employees based on instructions from DHRM. The statement should account for the full cost to the State and the employee of cash compensation as well as Social Security, Medicare, retirement, deferred compensation, health insurance, life insurance, and other benefits.

2. The Governor and the General Assembly may wish to direct the development of a total compensation strategy that builds from the current workforce planning approach and is further integrated into the State's strategic planning and budget process. The total compensation strategy should identify principles and goals to assist in managing salaries and benefits. The total compensation strategy should also identify the specific actions the State will undertake to be consistent with and achieve the principles and goals.

3. The General Assembly may wish to create a compensation advisory council comprised of the directors of the Department of Human Resource Management (DHRM), Department of Planning and Budget (DPB), the Virginia Retirement System (VRS), the House Appropriations Committee, and the Senate Finance Committee, and the Executive Secretary of the Virginia Supreme Court. The council should be supported by a small staff of full-time analysts at DPB, DHRM, and VRS. The staff should provide analytic support and expertise that facilitate more purpose-driven, goal-oriented, and coordinated assessment of salaries and benefits. The General Assembly may wish to direct the advisory council to report annually on employee compensation and to provide analysis of the fiscal, operational, and human resource impact of proposed changes to compensation during each legislative session.

4. The Department of Human Resource Management (DHRM) should work with selected agencies to provide further structure and guidance in the classification system and pay bands, where appropriate. This could be accomplished by creating additional structure within job roles that have substantial variation among working titles, better articulating career paths or levels (for example, management, professional, technical, or support) within or across job roles, and/or creating new occupational families, career groups, or job roles. DHRM and selected agencies should work together to identify the specific job roles in need of further structure. These agencies should also collaborate as necessary to create additional structure and/or provide more guidance about what to pay employees within the existing pay bands.

5. The Department of Planning and Budget should revise its Decision Package Narrative Justification form to require agencies requesting additional funds for employee salaries to address: the extent to which current salaries are recruiting, retaining, and motivating employees; how total compensation compares to what is offered by other relevant employers for similar positions; and the impact on the agency's inability to provide services and recruit, retain, and motivate employees.

Appendix A Study Mandate

A Resolution of the Joint Legislative Audit and Review Commission directing staff to study compensation for employees of the Commonwealth.

Authorized by Commission on November 13, 2006

WHEREAS, the Joint Legislative Audit and Review Commission is charged by §30-58.1 of the *Code of Virginia* to evaluate the effectiveness and efficiency of State agencies and operations and by §30-80 of the *Code of Virginia* to provide continuing oversight of the Virginia Retirement System; and

WHEREAS, compensation for employees of the Commonwealth consists of salaries and benefits including retirement, health insurance, group life insurance, leaves of absence, long-term disability, a cash match for deferred compensation, and other indirect benefits such as flexible work schedules and telecommuting, career development, and wellness programs; and

WHEREAS, salary and benefit costs for State employees account for approximately 22 percent of the Commonwealth's annual total expenditures and approximately 65 percent of operating expenditures; and

WHEREAS benefits are an increasingly significant portion of the overall costs of compensation; and

WHEREAS, the 2000 General Assembly passed legislation that replaced the State's 40-year-old compensation system with a performance-based compensation plan which contained new pay practices, greater opportunities for career growth within State government, greater management flexibility and accountability, and new ways to recognize and reward exceptional employee performance and acquired skills; and

WHEREAS, significant changes in the provision of retirement, health, and other benefits by both public and private organizations have been implemented in recent years; and

WHEREAS, in a 2005 study, *Impact of an Aging State Workforce*, the staff found that the Commonwealth is presented with a variety of challenges and opportunities by an aging workforce; and

WHEREAS, the State needs to maintain competitive salaries and benefits in order to recruit and retain qualified employees, but a comprehensive review of both salaries and benefits for State employees has not been completed for many years; now, therefore, be it

RESOLVED by the Joint Legislative Audit and Review Commission that staff are directed to study compensation for employees of the Commonwealth. In conducting its study, the staff are directed to (i) review the adequacy of salaries and benefits for State employees, (ii) determine the appropriate mix of salaries and benefits in total compensation, (iii) identify alternative benefits that could be provided to employees, (iv) assess the advantages, disadvantages, and costs of defined benefit, defined contribution, and hybrid retirement plans for public employees; (v) assess the appropriateness of the provisions and requirements of each of the retirement systems administered by the Virginia Retirement System; and (vi) compare current salaries and benefits for State employees to those provided by other public and private employers. The staff shall make recommendations for the compensation of employees of the Commonwealth that promote the recruitment and retention of a qualified workforce, maximize employee productivity and work performance, address the long-term growth of retirement and other benefit costs, maximize benefit flexibility and choices for employees, enhance employee job satisfaction, and minimize administrative workload and costs for State agencies.

The staff may hire consultants or experts it considers necessary for the completion of the study. The costs of consultants or experts for analysis of retirement benefits shall be paid for from funds of the Virginia Retirement System pursuant to §30-84 of the *Code of Virginia*. The costs of consultants for any other analysis or advice shall be paid for from additional general fund appropriations to the Commission for that purpose.

In completing the study, the staff shall consider information from employees, agencies, persons knowledgeable about compensation and benefits, and other interested individuals or organizations. The staff shall determine the manner in which it shall solicit and use such information. The staff shall consult with the staffs of the Senate Finance Committee and the House Appropriations Committee and periodically inform the Commission and the committees on the progress of the study. The staff shall consult with the Department of Human Resource Management and the Virginia Retirement System. All agencies of the Commonwealth are requested to provide assistance to the staff in the completion of this study. In addition, all local government agencies and other local entities participating in the Virginia Retirement System are requested to assist the staff.

The staff shall complete its work and submit a report of its findings and recommendations to the Commission by October 30, 2008.

Appendix

B Issues Referred to JLARC Staff by 2007 and 2008 General Assembly

During the 2007 and 2008 General Assembly Sessions, legislators introduced a variety of bills to change public employee compensation. The bulk of these bills focused on changing retirement benefits for State employees and teachers. This appendix includes commentary by JLARC staff about the issues raised in the bills that were referred to JLARC staff.

Bill Number and Summary	JLARC Staff Commentary
HB 1731, HB 2693, HB 2094, SB 813, HB 2172, HB 2519 (2007) Bill(s) Summary: Return-to-work for selected State and local, and all employees	Return-to-work legislation would allow employees to retire from the State and then return to work for the State full time, while still receiving monthly VRS benefits. In instances where an agency is experiencing high turnover and/or vacancy rates for mission-critical positions, a return-to-work initiative could provide temporary help. Its impact on agencies' broad staffing problems is likely to be minimal, but could be an effective tool in targeted instances. For example, HB 1731 and HB 2693 were introduced to address the high turnover and vacancy rates for the State's psychiatric nursing staff. The Department of Mental Health, Mental Retardation and Substance Abuse Services (DMHRSAS) reported that the agency's psychiatric nurse turnover rate averaged 24 percent in 2006. DMHMRSAS stated that this turnover, coupled with projections that Virginia's demand for nurses will be 30 percent greater than its supply in the next several years, indicate that "meeting the current and future demand for nurses will be extremely difficult to achieve through enhanced recruitment alone." A return-to-work initiative for nurses could help DMHMRSAS and other nurse-dependent agencies temporarily address staffing shortages by retaining experienced nursing staff. The State's experience with the teacher return-to-work program suggests that participation is likely to be low. From a budgetary perspective, because an agency would have to pay new staff to replace retiring staff, having retirees draw their pension as well as a salary is likely to be cost neutral. From an actuarial perspective, according to VRS return-to-work programs are only cost neutral if they do not affect existing retirement patterns – the current program has a one-year break in service requirement to address this concern. If any such initiative is to be ongoing it should be reviewed periodically for its effectiveness, cost, and continued need. Therefore, the General Assembly may wish to extend the current sunset provision for the teacher return-to-work initiative and insert a sunset provision into any other return-to-work initiatives it permits. There is no evidence that a return-to-work initiative is necessary for the entire classified workforce. In addition, if such an initiative were to inadvertently encourage employees to retire before they otherwise would have in order to receive this benefit, this initiative could be more costly if applied to the entire workforce. Return-to-work initiatives can be an appropriate means of addressing agencies' staffing challenges when circumstances justify its use.

Bill Number and Summary	JLARC Staff Commentary
HB 2774 (2007) <u>Bill(s) Summary</u>: Judges can retire after 18.5 years of actual service, regardless of age	Judges are eligible to first retire at age 60 with 30 years of service. However, judges' actual service in JRS is multiplied by 3.5 if they were appointed prior to January 1, 1995, and 2.5 if appointed after that date. Additionally, there is a statutory cap on judges' income replacement from JRS retirement benefits of 78 percent. This bill would allow JRS members to maximize the statutory income replacement cap of 78 percent. However, members appointed at age 42 or older would have to work past age 60—the minimum age for full retirement benefits—in order to achieve this level of income replacement. The average appointment age for judges has ranged from 48 to 52 over the past 10 years. In addition, this bill would result in members remaining in the State's health-care plan after they retire for longer than is currently possible, which would increase the State's other post-employment benefits (OPEB) liabilities. As stated in Chapter 5 of this report, the trend among public employers is to decrease exposure to OPEB liabilities. Advocates for this bill suggested that State employees' ability to retire at age 50 after 30 years of service is not equivalent to the JRS requirement that members can retire only after reaching age 60 and 30 years of service. However, the JRS service multiplier, when considered alongside the statutory income replacement cap of 78 percent, suggests that equity between JRS and VRS benefits is not a reasonable guiding principle when considering this bill. Because of the weighted service provision for judges, a judge may have creditable service far in excess of 30 years before he reaches age 60 if he or she is appointed to the bench at a young age. Still, for State employees to achieve an income replacement of 78 percent (the JRS maximum), the State employee would have to work 46 years—a judge would have to work 18 years and six months to receive this retirement benefit. (Although the mandatory retirement age of 70 means that a judge appointed after age 51 and a half will not be able to achieve the full 78 percent income replacement.) Finally, whereas some judges may accrue creditable service that exceeds 30 years, their creditable service (which is 2.5 or 3.5 times greater than their actual service) is used to calculate the amount of their health insurance credit benefit. A State employee with 15 years of service would be eligible for a monthly credit of $60, but a JRS member with the same amount of actual service would be eligible for $150, assuming a weighted service factor of 2.5, or $210 assuming a factor of 3.5.
HB 1941, HB 2956 (2007) <u>Bill(s) Summary</u>: Create a Defined Contribution retirement plan and enroll all new employees	See Chapter 5 for a discussion of the impact that a defined contribution plan would have on the State's purposes of compensation and level of financial cost and risk.

Bill Number and Summary	JLARC Staff Commentary
HB 1637, HB 1882, HB 1915, SB 1087 (2007) Bill(s) Summary: Increase retirement benefit multiplier for teachers to 2.0 percent/ Broaden qualifying compensation	Since 2000, public school teachers in Virginia have been the employee group most likely to retire prior to normal retirement age (65 years). Further, PricewaterhouseCoopers' (PwC) assessment of the income replacement provided to teachers indicates it is adequate. These two facts collectively make it difficult to argue that additional income replacement for teachers during retirement is a prudent expenditure of retirement system resources provided by taxpayers and retirement system investments. Four of five states neighboring Virginia offer their teachers a higher benefit multiplier than Virginia, but all require an employee contribution of at least five percent of salary. Virginia requires a five percent employee contribution, but this contribution is in fact paid by the employer on behalf of the employee. The VRS fiscal impact statement indicates this increase could cost between $227.6 million and $579 million in State and local funding by 2013, depending on implementation. There is no VRS precedent to include non-salaried compensation in retirement benefits. Because of the cost impact on the employer, it is possible that employers would be less likely to grant overtime pay. Moreover, expanding creditable compensation increases pension liabilities, and some localities have expressed concern about the cost of the retirement benefits. Finally, some employers have experienced negative and costly outcomes when allowing non-salaried compensation to be included in creditable compensation, and the trend among employers is to actually narrow the definition of creditable compensation. The VRS fiscal impact statement indicates this increase could cost $9 million in local funding by 2013.
HB 1756 (2007) Bill Summary: Include Department of Juvenile Justice probation and parole officers in VaLORS.	See Appendix D for discussion and analysis of SPORS and VaLORS membership.
HB 1870 (2007) Bill(s) Summary: Allow employees to purchase retirement service for additional types of military service	This bill would amend the *Code of Virginia* to list National Guard service as one of the types of prior military service that can be purchased and would remove the requirement that military service must be active duty in order to be purchased. The State allows employees to purchase prior service at less than the actuarial rate if they do so within the first three years of VRS-covered employment. This would expand the number of employees and types of service that can be purchased at the discounted rate, which represents a cost to the State. Moreover, employees with prior National Guard or inactive-status military service may be more likely to belong to the VaLORS or SPORS retirement plans, both of which have lower funded statuses. Proposed changes are not likely to help the State better the State's purposes, as JLARC's overall analysis concluded that the State's retirement plans currently allow employees to retire at an appropriate age and career point. VRS estimates this change would increase unfunded liabilities and contribution rates.

Bill Number and Summary	JLARC Staff Commentary
HB 1972, SB 975 (2007) Bill(s) Summary: Allow higher education faculty and staff who are members of the Optional Retirement Plan and have ten years of service a one-time opportunity to opt into the VRS defined benefit plan	The Optional Retirement Plan (ORP) was offered to higher education faculty because there is less certainty that faculty will remain employed with the State for their entire career. The defined contribution ORP account gives these faculty a more portable, though not guaranteed, retirement benefit. This bill would result in shifting investment risk from employees to the State, to the extent that ORP members elect to switch their membership to the defined benefit plan. Notably, the ORP does not allow for the purchase of prior service. Once an employee opts into the VRS defined benefit plan, he or she would be eligible to purchase prior service at less than the actuarial rate (absent a change in legislation). This might be attractive to ORP participants close to retirement, resulting in adverse selection and higher costs to the State. Employees who would prefer membership in VRS could be longer-tenured employees who are more likely to use the disability benefits available to VRS members. This potential adverse selection would increase State costs. VRS believes that a large number of employees would elect to switch to the defined benefit plan. While the bill provides that these transfers would be made on an actuarial cost-neutral basis, there is the potential for increased State disability costs and costs related to the purchase of prior service. It is possible that ORP members will not have sufficient ORP balances to purchase equivalent service in VRS. VRS data show that the approximate ORP account balance for higher education members with between 10 and 11 years of service is \$74,000. This is not enough to purchase a full 10 years of service—an ORP higher education member with 10 years of service and a salary of \$68,000 would need approximately \$90,000 to purchase equivalent service in the defined benefit plan.
HB 1973 (2007) Bill Summary: State contributions to the Optional Retirement Plan for higher education faculty and employees would be no less than the percentage contribution rate in effect for VRS members, including the five percent member contribution	The Optional Retirement Plan (ORP) is a defined contribution plan that provides greater retirement benefit flexibility and portability to faculty and administrators at institutes of higher education. The ORP was developed because non-tenured faculty desired the option to participate in a retirement plan with greater portability and flexibility, as opposed to the less-portable VRS defined benefit plan. Because VRS plans have a defined benefit design and the ORP has a defined contribution design, the structure and funding objectives of the plans are fundamentally different. The objective of making contributions to the VRS plan trust funds is to prefund promised VRS defined benefits. While the State does pay a 5 percent member contribution to a VRS member's account, the account is only refundable should the member choose to leave the system without retiring. The contributions paid by the State to VRS have no direct bearing on the size of the employees' retirement benefit. VRS funding decisions therefore consider the overall health of the State pension funds, not adequacy of individual retirement accounts. In contrast, the objective of making contributions to higher education ORP defined contribution accounts is to provide employees with a discrete, individual retirement savings account. The size of contributions to these accounts has a direct bearing on the value of employees' retirement savings, and employees own the value of their accounts. ORP funding decisions should therefore consider the adequacy of the defined contributions that the State pays to ORP accounts on behalf of members, not whether or not the rate is higher or lower than the VRS funding rate. Currently, the State contributes the equivalent of 10.4 percent of a member's salary to their ORP plan. ORP members, while not required to contribute to their own plan, may elect to contribute additional money up to the limits set by the IRS. Universities in Virginia's neighboring states offer similar defined contribution retirement plans to eli-

Bill Number and Summary	JLARC Staff Commentary
	gible higher education faculty and administrators. Virginia's ORP contribution rates are generous compared to most of these plans (see table below), indicating that there is no regional market incentive to increase ORP contribution rates beyond current levels.

State (University)	Employer Contribution	Member Contribution
Virginia (All)	10.4%	Allowed but not required
Kentucky (University of Kentucky)	10%	5% required
Kentucky (University of Louisville)	7.5% base (plus 2.5% match)	Allowed but not required
Maryland (All)	7.25%	5% required
North Carolina (All University of North Carolina System Schools)	6.84%	6% required
Tennessee (All University of Tennessee System Schools)	10% to 10.7% (depending on salary)	Not allowed
West Virginia (West Virginia University, Marshall University)	6%	6% required

Virginia's ORP is also competitive when compared to defined contribution plans offered by private sector employers. According to analysis performed by PricewaterhouseCoopers, private sector defined contribution plans are often "match" plans where the employer contributes funds as a match to member contributions. The most common match is 50 percent to 100 percent of the first six percent contributed by employees, a much lower employer contribution than the 10.4 percent offered under Virginia's ORP.

Given the competitiveness of the current Virginia ORP benefit with both public and private sector employers, increasing the ORP contribution rate does not seem merited. Furthermore, data indicates that VRS contribution rates do not regularly outpace ORP contribution rates, and in years in which VRS contribution rates are higher the differences between the two rates remains small. VRS contributions exceeded ORP contributions four times in the past ten years by an average of 0.57 percent of payroll. In FY 2007, the State's contribution rate to the ORP was 10.4 percent of payroll, compared to 10.74 percent of payroll to the VRS trust fund – a difference of only 0.34 percent.

VRS estimates the impact of this change at $8 million in FY 2013.

Bill Number and Summary	JLARC Staff Commentary
HB 2718, SB 1156 (2007) Bill(s) Summary: Index supplement to Social Security age for VaLORS	These bills would allow those VaLORS members who are eligible for the hazardous duty supplement to receive the supplement up until their normal retirement age under Social Security, as is allowed for members of SPORS and local enhanced plans. In effect, eligible members would receive the supplement (currently $11,508 per year) an additional zero to two years, depending on the member's birth date. Note that VaLORS members hired after July 1, 2001, are not eligible for the hazardous duty supplement, so this would only impact some current members and would have no impact on future members. The hazardous duty supplement is intended to provide a supplemental income that allows employees who perform hazardous duties to retire with fewer years of service. The supplement's temporary nature indicates that the purpose is to help employees bridge the gap from their younger-age retirement to the point when they can collect Social Security income. Extending VaLORS member's eligibility for the supplement from 65 to a member's normal retirement age under Social Security would better meet this goal and would bring these VaLORS members into alignment with other supplement-eligible employee groups. However, the State does not currently have a problem with VaLORS employees staying on the job longer than the State desires, so changes would have a minimal impact on the State's purposes of having employees retire at the right time with adequate benefits. Note that under all enhanced benefits plans - SPORS, VaLORS, and local enhanced plans - eligible members may continue to collect their hazardous duty supplement until age 65 or older even if they have chosen to collect early Social Security retirement benefits at age 62. This arrangement does not follow the reasoning that the supplement is intended to allow employees to bridge the gap from retirement to Social Security.
HB 3009 (2007) Bill Summary: Local juvenile detention facility employees members of the Law Enforcement Officers (LEOS) retirement system	This bill would allow political subdivisions to extend enhanced retirement benefit coverage to "local employees of juvenile detention facilities who provide direct care or supervision to detainees." This could presumably include both custodial employees (security personnel such as correctional officers) and non-custodial employees (nurses, counselors, others). Currently, custodial employees at local jails as well as the State's Department of Juvenile Justice and Department of Corrections are provided with enhanced benefits. However, no VRS-administered plan provides coverage to non-custodial correctional employees. JLARC's analysis of enhanced plan eligibility (Appendix D) suggests that employees who are obligated to protect the safety of others should be considered for enhanced benefits. In general, custodial corrections employees at adult and juvenile facilities appear to meet this criterion and non-custodial corrections employees do not. Providing enhanced benefits to non-custodial employees at local juvenile correctional institutions would be inconsistent with these findings.

Bill Number and Summary	JLARC Staff Commentary
SB 367 (incorporates SB 491 and SB 599) Bill(s) Summary: Special Forest Wardens receive enhanced benefits	Appendix D of this report assesses occupations based on job-related risks they encounter, responsibilities they are obligated to carry out, and public safety roles they perform. Special Forest Wardens (SFW) were among the groups assessed. The assessment found that SFWs could be considered eligible for enhanced benefits based on risks they encounter when performing public safety roles as wildfire fighters. While SFWs respond to wildfires instead of structural fires, they may still experience personal risks that are somewhat comparable to those experienced by other firefighters. However, the assessment also found that SFWs do not perform the same fire-rescue role as other firefighters and so their actions are less likely to impact the safety of others. For example, local fire departments respond to structural fires, which sometimes entails rescuing persons who have unexpectedly become trapped by fire or smoke and are in a position of imminent danger. The ability to perform an emergency rescue is therefore a crucial skill for local firefighters, and one reason they are allowed to retire early with enhanced benefits is because they may be less able to perform this skill as they age. In contrast, wildfires in Virginia rarely place civilians in the same position of imminent danger that a structural fire does, and SFWs do not routinely engage in rescues akin to those of other professional firefighters. An age-related decline in an SFW's physical ability is therefore not as likely to put another person at risk. In addition to responsibility differences, SFWs do not meet all requirements the State has put in place for those Virginia firefighters who currently qualify for enhanced benefits. Specifically, to be eligible for enhanced benefits, employees of local fire departments must serve as "full-time salaried fire fighters" or "full-time salaried emergency medical technicians." SFWs, who are listed under the working title of forester or forest technician, are not full-time, year-round firefighters and do not have EMS responsibilities. Given the differences between SFWs and full-time Virginia firefighters, SFWs appear more likely to qualify for partially enhanced benefits rather than fully enhanced benefits. This bill would provide SFWs with credit for days served fighting wildfires - a logical solution for addressing a group that only partially satisfies enhanced benefit criteria. However, there are potential administrative complications to implementing this approach. Specifically, a system for tracking and verifying each individual member's retirement credits would have to be put in place, and strong oversight would be required to ensure that the system is used correctly. Additionally, by creating a precedent for providing partially-enhanced benefits to a specific employee group, the State would likely become open to requests from other employee groups who only partially satisfy enhanced plan requirements. For example, Security Officers, Direct Service Associates, and Nurses at many DMHMRSAS facilities appear to partially qualify for enhanced benefits based on the risks that they encounter and the responsibilities they have for protecting the safety of colleagues and patients. Any increase in enhanced plan membership, even for partial benefits, will have a fiscal impact due to the higher per-member costs of these benefits. Currently, there are approximately 200 DOF Special Forest Wardens who would be eligible. In addition to the cost of providing a partially enhanced benefit, the need to track and verify member retirement credits could create additional administrative costs.

Bill Number and Summary	JLARC Staff Commentary
SB 316 and SB 417 (2008) Bill(s) Summary: Virginia Sickness and Disability Program open enrollment	SB 316 and SB 417 open the enrollment for the Virginia Sickness and Disability Program (VSDP) to eligible employees not participating in the program. Employees who choose to enroll may convert accrued sick leave balances to either retirement service credits or disability credits. This would present employees with a third opportunity to enroll in the program, which was implemented in 1999. During the first two enrollments, 35 and 36 percent of employees enrolled. VRS prepared a fiscal impact statement for these bills which addresses the impact of the change on the retirement system, VSDP, and VRS staff. Because non-VSDP participants tend to have more years of service, VRS actuaries report that "members may be able to retire approximately one year earlier by converting their sick leave balance to retirement service credits." Further, they indicate that this results in "an actuarial loss to the system" because this additional service credit was not included in prior valuations for employer contribution rates. VRS estimates an actuarial loss to the retirement system of $27 to $37 million over the next five years depending on whether 50 or 100 percent of eligible employees enroll. This loss would be reflected in higher employer contributions in the years following the open enrollment. VRS also indicated that increased enrollment would add to the administrative costs of VSDP and would require an additional full-time equivalent position at VRS. Although VRS highlights the costs associated with this change that directly impact VRS and VSDP, consideration must also be given to other factors that could outweigh these costs. For instance, this change would reduce the State's long-term liability for funding employees' cumulative sick leave balances. Under the traditional sick leave system, employees are compensated for 25 percent of their unused balances when they terminate employment, up to a maximum of $5,000. Department of Human Resource Management staff estimate this liability to be over $50 million. This liability would be reduced as employees enroll in VSDP. Perhaps more importantly, VSDP was designed, in part, to reduce the cost of disability retirements, decrease unplanned absences, minimize long periods of disability by assisting employees' return to work, and provide a review of disability cases by a third party vendor. To the extent that this program is achieving these goals, the positive impact on employee productivity and State costs should also be considered among the bill's impacts. A more thorough analysis of the impact of VSDP on employee absences and corresponding costs to the State is needed to more clearly demonstrate the appropriateness of this and future legislation regarding VSDP.
Virginia Beach Disability Benefits (2008)	JLARC staff were asked to look into the disability retirement rate of Virginia Beach public safety officers. Analysis focused on work-related disability retirements and found that from fiscal year 2001 to 2007, 35 percent of Virginia Beach's LEOS retirements were work-related disability retirements. This rate was compared to the rate of work-related LEOS disability retirements at five other VRS-participating localities that share the same public safety structure as Virginia Beach (that is, each locality has a Police Department responsible for law enforcement and a Sheriff's Office responsible for managing jails). Of these localities, Virginia Beach had the highest percentage of LEOS employees retiring under a work-related disability (see table, next page). One possible reason for Virginia Beach's higher work-related disability retirement rate could be that it has more stringent physical requirements for LEOS officers than other localities. Local police chiefs, sheriffs, and training academies may require their officers to meet minimum job duty requirements, including the ability to perform specific physical activities such as running, jumping, lifting, and self-defense (note that the State does not require Virginia law enforcement officers to meet any on-going minimum physical requirements outside of their initial training).

Bill Number and Summary	JLARC Staff Commentary

Locality	LEOS Work-Related Disability Retirements as % of all LEOS Retirements (FY 2001-2007)
City of Virginia Beach	35%
City of Chesapeake	28
Chesterfield County	8
Henrico County	9
City of Portsmouth	0
Roanoke County	10

Despite the potential for different localities to mandate different job requirements, this does not appear to be the reason why Virginia Beach has a higher work-related disability retirement rate. A review of a random sample of 18 approved work-related disability retirement applications filed by LEOS members from Virginia Beach, Chesapeake, and Henrico County found that all three localities require police officers with field duties (patrol, service call response, investigations, warrant execution) and sheriff's deputies with inmate management duties (incident response) to be capable of performing the physical activities associated with these jobs. Applications filed by employees in managerial positions indicated that mid-management LEOS positions (sergeant, lieutenant) entail occasional field work or inmate management duties requiring physical activity, but that upper-management LEOS positions (major, captain) are not regularly required to perform such activities. It may therefore be possible for persons in upper-management positions to effectively perform the vast majority of their job requirements even if they suffer a physically debilitating injury. It is less clear if upper-management officers are capable of performing a majority of their job requirements if they suffer from a heart condition, as the non-physical stressors associated with managing police operations may exacerbate such a condition. This is a significant issue because heart disease and hypertension are statutorily-determined to be work-related for LEOS members.

To determine the rate at which LEOS members retire under the *Code of Virginia's* heart presumption, JLARC staff reviewed a sample of 53 medical board approval letters for retirements taking place in fiscal years 2001, 2003, and 2007 for applicants from Virginia Beach, Chesapeake, and Henrico. The review found that 32 percent of Virginia Beach's LEOS work-related disability retirements were due to a heart condition, accounting for 11 percent of all Virginia Beach LEOS retirements in the years examined. This was higher than either Chesapeake (10 percent of all Chesapeake LEOS retirements) or Henrico (two percent of all Henrico LEOS retirements). Additionally, the review found that 25 percent of Virginia Beach employees (three of 12) and 50 percent of Chesapeake employees (two of four) who retired due to a work-related heart condition were in upper-management positions such as captain or major. As there are typically far fewer employees in upper-management positions, this data indicates that both Virginia Beach and Chesapeake had a high proportion of upper management police officers retiring under a heart presumption relative to other LEOS positions. Only one Henrico LEOS member, a police sergeant, retired under a heart disease presumption during the period examined.

Another possible reason for Virginia Beach's higher work-related disability retirement rate could be fraud or abuse. However, a review of 18 work-related disability retirement application case files and 53 medical board letters found no obvious evidence of fraud or abuse. The review, however, did not attempt to document the veracity of opinions or condition diagnoses provided by medical professionals in each application package.

Bill Number and Summary	JLARC Staff Commentary
	While no fraud or abuse was apparent, the review did find three cases in which the causal link between an employee's disabling injury and a work-related activity were not clear. Cases were from three separate localities. No trends were evident. Regardless of the reasons for Virginia Beach's higher work-related disability retirement rate, it is clear that this higher rate of work-related disability retirements carries costs and liabilities that could be burdensome to the locality. A manner to address these costs would be to allow localities to establish managed disability programs. Legislation in this respect has been previously introduced, most recently in 2005 as HB 1747. The City of Virginia Beach has also proposed several approaches, including allowing disabled public safety employees to retain their LEOS benefit if they accept a non-public safety position, using member contributions to fund disability costs instead of refunding them to job-related disability retirees, and requiring a disabled employee to accept another job for which he is qualified if unable to perform the job for which he was hired (unless injury is catastrophic).

Appendix C Research Activities and Methods

JLARC staff conducted four major types of research activities to address the study mandate:

1. Analysis of existing datasets about employee salaries and benefits;
2. Interviews to obtain employer and employee perspectives;
3. Developing and administering surveys to gain further perspective from employers and employees; and
4. Procurement of analytical and consulting support from Mercer and PricewaterhouseCoopers (PwC).

ANALYSIS OF EXISTING DATASETS ABOUT EMPLOYEE SALARIES AND BENEFITS

JLARC staff utilized numerous existing datasets maintained by the Department of Human Resource Management (DHRM), Virginia Retirement System (VRS), Department of Planning and Budget (DPB), and Auditor of Public Accounts (APA). The major datasets and their use are briefly highlighted below.

DHRM provided an extract of information about classified employees included in the Personnel Management Information System (PMIS). JLARC staff used this extract for numerous analyses, including: general background information and demographics characterizing the classified State workforce; number of employees at each agency; number of, and salaries paid, to employees in each job role, career group, and occupational family; and number of, and salaries paid, to employees in each pay band.

DHRM also provided numerous separate data files, which JLARC staff used to assess the health insurance and leave benefits. DHRM provided reports addressing employee and agency turnover and retirement eligibility, as well as reports about employee leave usage by tenure and leave balances. DHRM and Anthem also provided demographic and cost information associated with the State's health insurance plans.

VRS provided extracts of information about membership in the Virginia Retirement System, specifically regular VRS employees, SPORS, VaLORS, judges, school division, and local employee plans. JLARC staff used these extracts for numerous analyses, including general background information and demographics characterizing retirees and historical trends in employee retirement patterns and income replacement levels.

VRS and its actuaries provided actuarial files (such as valuations and experience files) that were used by both JLARC staff and actuaries at PwC. This information was used to conduct analyses and make projections about the historical, current, and future financial status of each major retirement plan. This information was also used by PwC to assess the current plans and estimate the projected impact of the options discussed in Chapter 5.

Additionally, JLARC staff used information from DPB and APA. DPB provided recent decision packages submitted by agencies requesting additional funds for employee salaries, which JLARC staff assessed against the criteria for a sound business case discussed in Chapter 3. At various points during the study, summary spending information from the APA Data Point system was used to identify recent historical patterns in total compensation spending.

INTERVIEWS TO OBTAIN EMPLOYER AND EMPLOYEE PERSPECTIVES

JLARC staff conducted more than 100 interviews with representatives from various State and local organizations and employees to gain a more complete understanding of the extent to which the salaries and benefits were achieving their intended purposes. Some of these are highlighted below:

Virginia State Agencies	
• Department for the Blind & Vision Impaired	• Department of Social Services
• Department of Alcoholic Beverage Control	• Capitol Police
• Department of Charitable Gaming	• Haynesville Correctional Center
• Department of Conservation and Recreation	• Indian Creek Correctional Center
• Department of Correctional Education	• Longwood University
• Department of Corrections	• Northern Virginia Community College
• Department of Criminal Justice Services, Standards and Training Section	• Northern Virginia Mental Health Institute
• Department of Environmental Quality	• School for the Deaf & Blind, Hampton
• Department of Forestry	• Southern Virginia Training Center
• Department of Game and Inland Fisheries	• The College of William & Mary
• Department of General Services	• University of Virginia
• Department of Human Resource Management	• Virginia Commonwealth University
• Department of Juvenile Justice	• Virginia Department of Health
• Department of Legislative Services	• Virginia Department of Transportation
• Department of Mental Health, Mental Retardation, and Substance Abuse Services	• Virginia Information Technology Agency
• Department of Military Affairs	• Virginia Polytechnic Institute and State University

• Department of Mines, Minerals, and Energy	• Virginia State Lottery
• Department of Motor Vehicles	• Virginia State Police
• Department of Planning and Budget	• Virginia Retirement System
• Department of Rehabilitative Services	• Virginia Marine Resources Commission
Classified State Employees	
• University of Virginia trades technicians	• Department of General Services procurement staff
• Virginia Department of Transportation transportation operators	• Southside Virginia Training Center direct service associates
• Virginia Department of Transportation architect/engineers	• Haynesville Correctional Center corrections officers
• Virginia Polytechnic Institute and State University food service technicians	• Indian Creek Correctional Center corrections officers
• Northern Virginia Mental Health Institute direct service associates	• Virginia Department of Health registered nurses
Local Government / School Divisions	**Local Government Employees / Teachers**
• City of Alexandria	• City of Alexandria (regular VRS)
• Augusta County	• Augusta County (LEOS)
• Botetourt County	• Botetourt County (regular VRS)
• Chesterfield County	• Chesterfield County (regular VRS)
• Frederick County	• Frederick County (LEOS)
• Henrico County	• Henrico County (LEOS)
• Loudon County	• Loudon County (regular VRS)
• Mecklenberg County	• Mecklenberg County (Teachers)
• Russell County	• Russell County (Teachers)
• Virginia Beach	• Virginia Beach (Teachers)
• Wise County	• Virginia Beach (LEOS)
	• Wise County (regular VRS)
Other Organizations, States, and Associations	
• Anthem	• Virginia State Police Association
• Minnesota Retirement System	• Virginia Association of Counties
• Montana Retirement System	• Virginia Municipal League
• State of Georgia	• Virginia Association of School Superintendents
• State of Missouri	• Virginia Education Association
• State of Montana	• Virginia Governmental Employees Association
• State of South Dakota	• Virginia Professional Firefighters Association
• Virginia Institute for Government	• Virginia Sheriffs Association

DEVELOPING AND ADMINISTERING SURVEYS TO GAIN FURTHER PERSPECTIVE FROM EMPLOYERS AND EMPLOYEES

To further determine whether the purposes of compensation were being met, JLARC staff developed and administered three major surveys: a survey of agencies that employ classified staff, a survey of classified State employees, and a survey of employees who left State employment during FY 2008. Each of these survey efforts is briefly described below.

In Fall 2007, JLARC staff surveyed agencies that, according to DHRM records, employed classified staff. The survey was administered online using JLARC staff's survey software. A pre-test of a draft survey was conducted prior to administering the survey and minimal changes were made to the draft survey based on pre-test respondent issues and comments prior to its administration. The survey asked agencies to express their views about the salaries and benefits provided to employees. The first section consisted of 26 questions about the compensation package offered to employees, and allowed agencies to discuss any problems with recruiting, retaining, and motivating employees. The second section was optional but recommended for agencies that experience difficulties recruiting, retaining, or motivating employees within specific career groups or job roles. The 16 questions posed in this section could be completed multiple times if concerns differed across various career groups or job roles.

Ninety-one percent, or 132 of the 145 agencies notified of the survey, responded to the survey. These 132 agencies employed 62,833 classified staff, which was 88 percent of total State classified employment. There was no discernable pattern in agency type or size among the remaining 13 agencies that did not respond.

Between January and April 2008, JLARC staff surveyed classified State employees. The survey was administered online using JLARC staff's survey software. A pre-test of a draft survey was conducted prior to administering the survey and minimal changes were made. The survey asked employees to express their views about the salaries and benefits they receive. Major topics addressed included the extent to which employees agreed the purposes of salaries and benefits were being achieved and levels of satisfaction and reasons for dissatisfaction. The survey also included a series of 13 questions developed by Mercer to ascertain the relative importance employees place on the various elements of total compensation (e.g. salaries, 457 deferred compensation, work /life balance, etc.).

JLARC staff then worked with DHRM staff to create 31 separate e-mail notification lists. JLARC staff sent notifications to these groups in sequential order, usually between three days and one week apart. Follow-up notifications and reminders were also sent periodically, specifically when the projected response rate was comparatively lower than other previous notifications. Human resource officers also received a notification flier to display in prominent locations, providing employees who do not routinely have access to a computer at work the survey's internet address so they could complete the survey on a personal computer or other location. Thirty-eight percent, or 21,696 of the 58,068 notified employees, responded to the survey. Responses by agency varied, though

JLARC staff did not conduct analysis at a level that resulted in statistically insignificant sub-sets (e.g. female employees between 30 and 35 in the security services III job role with 10 to 15 years of service).

Between July 2007 and June 2008, JLARC staff surveyed employees who left State employment. The survey was administered primarily online, but paper surveys were used in circumstances in which employees had minimal access to a computer (e.g. trades technicians, transportation operators, etc.). JLARC staff provided a one-page flyer to the human resources offices at each agency that employed classified staff. JLARC staff requested that the flier be given to employees when they notified their agency that they were leaving their current position (but not those who were terminated or retiring). The flier provided background information about JLARC, this review, and details about the survey, including the website where the survey was located.

A pre-test of a draft survey was conducted prior to administering the survey and minimal changes were made. The survey consisted of 22 questions covering the primary reasons why employees chose to leave, how total compensation at their new jobs compared to their current jobs', and what their agencies could have done to retain them. JLARC staff received 701 completed surveys during the time period. This represents approximately 13 percent of the 5,584 employees who voluntarily left during 2007.

PROCUREMENT OF ANALYTICAL AND CONSULTING SUPPORT FROM MERCER AND PRICEWATERHOUSECOOPERS

The General Assembly authorized JLARC staff to procure outside analytical support during this review. General funds were allocated to procure support assessing the State's total compensation and the VRS Board provided funds to procure support assessing retirement benefits. JLARC staff issued two Requests for Proposals (RFP) and awarded two separate contracts. Both procurements were competitive negotiation processes conducted in accordance with Department of General Services' procurement guidance and procedures.

On June 15, 2007, JLARC staff issued RFP #2007-001R requesting consulting, analytical, and actuarial services to support the retirement portion of the State employee compensation review. An optional pre-proposal conference was held on June 29, 2007. On July 13, 2007, JLARC staff received five proposals. An evaluation panel scored the proposals and selected three proposals for further consideration. After receiving presentations from each of the three vendors, the evaluation panel selected PwC for further negotiation.

JLARC staff entered into a contract with PwC on October 2, 2007. During the contract period, PwC provided analytical and consulting expertise, which culminated in three major deliverables:

- Detailed Review of Retirement Plan Trends, Best Practices, and Innovations by Other Public and Private-Sector Employers;
- Assessment of Virginia's Current Retirement Plan; and
- Analysis of the Projected Impact of Potential Plan Modifications.

On August 15, 2007, JLARC staff issued RFP #2007-002TC requesting consulting services to support the total compensation portion of the State employee compensation review. An optional preproposal conference was held on August 29, 2007. On September 12, 2007, JLARC staff received five proposals. An evaluation panel scored the proposals and selected three proposals for further consideration. After receiving presentations from each of the three vendors, the evaluation panel selected Mercer for further negotiation.

JLARC staff entered into a contract with Mercer on October 30, 2007. During the contract period, Mercer provided analytical and consulting expertise, which culminated in five major deliverables:

- Review of Total Compensation Trends, Best Practices, and Innovations;
- 2008 Total Remuneration Index;
- 2008 Benefits Valuation Report;
- Working Session: Total Rewards Competitive Comparison and Assessment (Binders 1 and 2); and
- Total Rewards Assessment Observations and Suggested Alternatives.

More information about the analyses performed by PwC and Mercer is available online at http://jlarc.virginia.gov/.

Appendix D

Review of Enhanced Retirement Plan Membership

The purpose of providing enhanced retirement benefits is to allow members of selected occupation groups to retire earlier due to the risks they encounter and duties they perform on behalf of the State. Allowing such employees to retire early reduces the risk of serious injury to the employee, colleagues, clients, and members of the public. This allows State agencies to better serve the public and achieve mission goals while simultaneously reducing their liability for workers compensation injury claims or other financial reparations. Currently there are no formal legislatively- or administratively-established criteria for enhanced plan membership. However, informal membership criteria have been established for the SPORS and VaLORS plans, and an assessment found that while actual SPORS membership reflects these criteria, VaLORS membership only partly reflects the criteria. Informal criteria limit plan membership to law enforcement groups, but VaLORS and local enhanced plan membership includes several other public safety occupations, suggesting criteria chould be expanded. JLARC staff have therefore developed guidelines that legislators can use to develop enhanced plan membership in a way that equitably achieves benefit purpose while effectively managing costs.

MEMBERSHIP IN THE STATE'S ENHANCED BENEFIT RETIREMENT PLANS PARTLY REFLECTS ESTABLISHED CRITERIA

The only statutory criterion for membership in either SPORS or VaLORS is to be part of a designated occupation group. For example, all "state police officers" qualify for SPORS membership. Despite no further statutory or administrative criteria, a review of the arguments surrounding the creation and later justification of SPORS and VaLORS show that three reasons for providing enhanced benefits were established as the principal criteria for membership consideration:

1. Employees regularly perform duties which may be considered hazardous;

2. Job requirements make employees less fit for duty as they age, with direct safety implications to colleagues and the public; and

3. Employees are law enforcement officers directly involved in the prevention and detection of crime and the enforcement of the

penal, traffic, or highway laws of the Commonwealth of Virginia.

A JLARC staff review of the job risks and responsibilities of current enhanced plan members found that SPORS membership largely reflects established criteria for enhanced benefit eligibility, whereas the majority of VaLORS membership reflects the first two criteria but, less so the third.

Current SPORS Membership Largely Reflects Established Criteria for the State's Enhanced Retirement Plans

SPORS membership, which includes most officers of the Virginia State Police, appears to meet the three criteria established for the State's enhanced retirement plans. First, a review of the principle occupation groups covered under SPORS indicated that most Virginia State Police officers are directly involved in enforcing the penal, traffic, and highway laws of the Commonwealth and regularly perform duties that may be considered hazardous. Second, it is the sworn duty of a Virginia State Police officer to "aid those in danger or distress" and an officer's actions can regularly have a direct impact on the safety of human life. An officer's ability to mentally and physically perform their job functions therefore has direct safety implications to the officer, colleagues, and the public. Third, all officers of the Virginia State Police are defined as law enforcement officers under the *Code of Virginia*. Implicit in this designation is a duty to serve and protect public safety – not just the safety of colleagues and clients.

Although most Virginia State Police officers are directly involved in law enforcement activities, some officers are assigned to less hazardous positions. For example, some officers may be predominantly involved in office or managerial work. These officers remain covered under the SPORS plan even though they do not have the same daily risk exposure encountered by officers who routinely work in the field. Despite the lower risk factor, allowing all officers to maintain their enhanced retirement benefit allows State Police to manage personnel through promotions and transfers, therefore allowing officers to stay with the agency throughout their careers.

Current VaLORS Membership Partly Reflects Established Criteria for the State's Enhanced Retirement Plans

The majority of groups currently in VaLORS reflect the informal criteria established for the State's enhanced retirement plans. VaLORS includes nine occupation groups at eight State agencies and 22 institutions of higher learning (see Table D-1). Membership is split between various law enforcement officers and other criminal justice officers employed under the Department of Corrections

Table D-1: Assessment of Current VaLORS Membership

Occupation Group	Regularly Performs Duties Which May Be Considered Hazardous	Job Performance has Direct Safety Implications to Colleagues and the Public	DCJS Certified Law Enforcement Officer Directly Involved in Prevention & Detection of Crime
ABC Special Agents	✓	✓	✓
Campus Police Officers[a]	✓	✓	✓
Capitol Police Officers	✓	✓	✓
DGIF Conservation Police Officers	✓	✓	✓
MRC Police Officers	✓	✓	✓
State Police Commercial Vehicle Enforcement Officers	✓	✓	✓
DJJ Corrections Officers	✓	✓	
DOC Corrections Officers	✓	✓	
DOC Probation Officers	✓		

[a] Includes campus police at 22 public universities and community colleges as well as the Woodrow Wilson Rehabilitation Center.

Source: JLARC staff job risk analyses of State occupations.

(DOC) and the Department of Juvenile Justice (DJJ). Law enforcement officers account for approximately nine-and-a-half percent of active VaLORS membership, half of whom are campus police officers. Non-law enforcement officers account for the remaining 90.5 percent, with DOC correctional officers accounting for almost 75 percent of active VaLORS membership, followed by DOC probation officers (eight percent) and DJJ correctional officers (eight percent).

All VaLORS-covered members appear to regularly perform duties which may be considered hazardous, with the overall level of job-related risk varying from one occupation to the next. Most VaLORS-covered employees also perform jobs in which their duties and actions have direct safety implications for colleagues and the public. However, one VaLORS-covered group, probation officers with DOC, carries out job functions that have relatively limited safety implications to colleagues and the public. This is because probation officers have only a limited obligation to maintain order within the Commonwealth and their actions rarely have a direct impact on another person's safety. In contrast, the law enforcement officers and correctional officers listed above are all primarily tasked with maintaining order and safety within their respective jurisdictions or institutions.

As noted above, VaLORS membership is split between law enforcement officers and other criminal justice officers employed by

DOC and DJJ. All VaLORS-covered law enforcement officers are to some degree directly involved in enforcing the penal, traffic, and highway laws of the Commonwealth. In contrast, none of the DOC and DJJ criminal justice officers covered under VaLORS have broad law enforcement powers or authorities. Note that a lack of law enforcement authority does not mean that these groups do not merit enhanced benefits, as discussed in the following section.

In addition to the occupations listed above, there are two State occupation groups that appear to meet all three established criteria for enhanced plan membership but who are not covered under SPORS or VaLORS. These groups are (1) police officers employed under the Department of Military Affairs at the Fort Pickett Police Department, and (2) special agents employed by the Department of Motor Vehicles. Another group, special and regular conservation officers employed by the Department of Conservation and Recreation appear to satisfy the criteria even though these employees are not "full time" law enforcement officers and have a relatively lower risk of assault than most covered groups. Lastly, security officers at some DMHMRSAS facilities have been appointed law enforcement officers and would therefore appear to satisfy criteria. However, these officers derive their powers and authority from temporary judicial appointments whereas other law enforcement officers are granted their powers and authority in the *Code of Virginia.* Unlike those law enforcement officers who have been granted legal authorities in *The Code,* judicially appointed officers could conceivably not be reappointed at some point in their career. Additionally, fewer than one-third of DMHMRSAS agencies employ security officers who have been appointed as law enforcement officers. These factors complicate DMHMRSAS law enforcement officers' case for membership.

ENHANCED PLAN MEMBERSHIP INCLUDES PUBLIC SAFETY OFFICERS MEETING MINIMUM RISK AND RESPONSIBILITY THRESHOLDS

There are several groups of State employees, law enforcement and non-law enforcement, who face an elevated risk of severe or life-threatening injury in the course of performing their jobs. Many of these employees are also responsible for maintaining order in State institutions or public jurisdictions, and their actions can directly impact the safety of others. Some of these employees are solely responsible for the safety of colleagues and clients (patients, inmates, juvenile offenders), but some are also responsible for public safety.

Currently, membership in both VaLORS and enhanced benefit plans offered through VRS-participating political subdivisions include occupations that perform public safety roles other than law enforcement. This suggests that all employees in public safety occupations could be considered eligible for enhanced benefits, provided they meet minimum risk and responsibility thresholds. Information on various State occupations and guidelines for making membership determination are provided below. Any adjustment to enhanced plan membership should take into account potential human capital impacts on State agencies, including unintended impacts of not providing certain groups with equivalent enhanced benefits.

44 State Occupation Groups Identified as Potentially Higher Risk

JLARC identified 44 occupations at 17 State agencies and 22 institutions of higher education that qualified as potentially higher risk occupations and assessed their level of job-related risk and job responsibilities (see Table D-2). Several steps were taken to select and score these occupations. First, a group of agencies likely to employ persons in higher-risk occupations were identified through State worker's compensation data and discussions with knowledgeable officials at the Department of Human Resources Management (DHRM) and the Virginia Retirement System (VRS). Officials at each candidate agency were then asked to identify occupations within their agency that could be viewed as higher risk. Agency officials also provided JLARC with information about job duties and related risks for employees in those occupations. Occupations that did not appear to be at elevated risk of assault, motor vehicle accident, fire-related incident, or another potentially life-threatening accident were removed from consideration by JLARC staff.

Relative Scoring Approach

The occupations presented in Table D-2 were determined to be more at risk of injury or death than the typical State employee, and many were found to perform duties where they are directly responsible for protecting the safety of others, including the public. A low risk or responsibility score therefore does not indicate an absence of that risk or responsibility - it simply indicates that the occupation has a relatively lower level of risk or responsibility when compared to the other 43 occupations.

Agency officials were then asked to complete a job risk questionnaire for each of their remaining occupations. Questionnaires required agencies to rate the frequency with which an employee in the given occupation experiences specific risks and carries out particular responsibilities. JLARC compared the responses given for each individual occupation to those reported for all other potentially higher risk occupations. Questionnaire responses, worker's compensation data, crime statistics, officer assault statistics, and interview information were then used to identify and score the relative risks and responsibilities of each potentially higher risk occupation (see sidebar). Additional information from the *Code of Virginia* and the Department of Criminal Justice Services was used to provide information on what exact powers and authorities, if any, have been granted to each occupation group.

Table D-2: Job Risk Analysis Summary Table

Agency	Occupation	Risks					Responsibilities					*Currently Eligible for Enhanced Benefits?*
							Protect Others		Public Safety Role			
		1. Personal Assault (Deadly Weapon)	2. Personal Assault (No Weapon)	3. Motor Vehicle Accident	4. Fire Related Incident	5. Other Job-Related Accident	6. Obligated to Maintain Safety Within a Jurisdiction or Institution	7. Action Directly Impacts Safety of Others	8. DCJS Certified Criminal Justice Officer	9. DCJS Certified Law Enforcement Officer	10. Emergency First Responder[a]	
Law Enforcement												
Dept. of State Police	Police Trooper, (Bur. of Field Operations)	●	●	●	◐	●	●	●	●	●	●	✓
Dept. of State Police	Police Officer (Bur. of Criminal Investigations)	●	●	◐	○	●	●	●	●	●	◐	✓
Public Universities, Community Colleges, & Woodrow Wilson Rehab Center	Campus Police Officer	●	●	◐	○	◐	●	●	●	●	●	✓
Marine Resources Commission	Police Officer	●	◐	◐	○	●	●	●	●	●	●	✓
Dept. of Military Affairs	Police Officer	●	◐	◐	○	◐	●	●	●	●	●	
Dept. of Game & Inland Fisheries	Conservation Police Officer	●	◐	◐	○	◐	●	◐	●	●	●	✓
Dept. of Alcoholic Beverage Control	Special Agent	◐	◐	◐	○	○	●	◐	●	●	◐	✓
Dept. of Motor Vehicles	Special Agent	◐	◐	◐	○	○	●	◐	●	●	◐	
Capitol Police	Police Officer	◐	◐	○	○	○	●	◐	●	●	●	✓
Dept. of State Police	Commercial Vehicle Enforcement Officer	◐	○	●	○	○	●	◐	●	●	◐	✓
Dept. of Conservation & Recreation	Special & Regular Conservation Officer	◐	○	○	◐	◐	●	◐	●	●	●	
Dept. of Charitable Gaming	Special Agent	◐	○	○	○	○	●	○	●	●	○	
Dept. of Juvenile Justice	Special Agent / Investigator	○	○	○	○	○	◐	○	●	●	○	
Dept. of Corrections	Internal Investigator	○	○	○	○	○	◐	○	●	●	○	
State Lottery	Lottery Investigator	◐	○	○	○	○	◐	○	●	●	○	
Community Corrections												
Dept. of Corrections	Probation Officer	◐	◐	◐	○	○	◐	○	◐[b]	○	○	✓
Dept. of Juvenile Justice	Probation Officer	◐	◐	◐	○	○	◐	○	◐[b]	○	○	
Dept. of Corrections	Surveillance Officer	◐	◐	◐	○	○	○	○	◐[b]	○	○	

Table D-2: Job Risk Analysis Summary Table (Continued)

Agency	Occupation	Risks					Responsibilities					*Currently Eligible for Enhanced Benefits?*
							Protect Others		Public Safety Role			
		1. Personal Assault (Deadly Weapon)	2. Personal Assault (No Weapon)	3. Motor Vehicle Accident	4. Fire Related Incident	5. Other Job-Related Accident	6. Obligated to Maintain Safety Within a Jurisdiction or Institution	7. Action Directly Impacts Safety of Others	8. DCJS Certified Criminal Justice Officer	9. DCJS Certified Law Enforcement Officer	10. Emergency First Responder[a]	
State Institutions (Custodial & Security Officers)												
Dept. of Corrections	Correctional Officer	◐	●	○	○	◐	●	●	●	○	○	✓
Dept. of Juvenile Justice	Correctional Officer	◐	●	○	○	◐	●	●	◐[b]	○	○	✓
DMHMRSAS – Forensic Mental Health Facilities	Security Positions (Includes Sec Officers & Some DSAs)	◐	●	○	○	◐	●	●	◐[b]	○	○	
DMHMRSAS – Non-forensic Mental Health Facilities	Security Officer	◐	●	○	○	◐	●[c]	●	◐[c]	◐[c]	○	
DMHMRSAS – Training and Medical Centers	Security Officer	○	◑	○	○	◐	●[c]	◐	◐[c]	◐[c]	○	
State Institutions (Non-Custodial Employees)												
DMHMRSAS – Mental Health Facilities	Direct Service Associate	◐	●	○	○	●	◐[d]	●	○	○	○	
DMHMRSAS – Mental Health Facilities	Nurse	◐	●	○	○	●	◐[d]	●	○	○	○	
DMHMRSAS – Training and Medical Centers	Direct Service Associate	○	◐	○	○	◐	◐[d]	◐	○	○	○	
Dept. of Corrections	Food Service Worker	○	◐	○	○	◐	○	◐	○	○	○	
Dept. of Corrections	Nurse	○	◐	○	○	◐	○	◐	○	○	○	
Dept. of Juvenile Justice	Nurse	○	◐	○	○	◐	○	◐	○	○	○	
DMHMRSAS – All Facilities	Counselors, Dentists, & Physicians	○	◐	○	○	◐	○	○	○	○	○	
Dept. of Juvenile Justice	Halfway House Employee	○	◐	○	○	○	◐[e]	◐	○	○	○	
Dept. of Juvenile Justice	Juvenile Correctional Center Counselor	○	◐	○	○	○	○	○	○	○	○	
Dept. of Correctional Education	Teachers & Instructional Assistants	○	◐	○	○	○	○	○	○	○	○	
Dept. of Juvenile Justice	Food Service	○	○	○	○	◐	○	◐	○	○	○	
DMHMRSAS – Training and Medical Centers	Nurse	○	○	○	○	◐	◐[d]	◐	○	○	○	

Table D-2: Job Risk Analysis Summary Table (Continued)

Agency	Occupation	Risks					Responsibilities					Currently Eligible for Enhanced Benefits?
							Protect Others		Public Safety Role			
		1. Personal Assault (Deadly Weapon)	2. Personal Assault (No Weapon)	3. Motor Vehicle Accident	4. Fire Related Incident	5. Other Job-Related Accident	6. Obligated to Maintain Safety Within a Jurisdiction or Institution	7. Action Directly Impacts Safety of Others	8. DCJS Certified Criminal Justice Officer	9. DCJS Certified Law Enforcement Officer	10. Emergency First Responder[a]	
Fire Suppression & Resource Management												
Dept. of Military Affairs	Firefighter	○	○	○	●	●	●	●	○	○	●	
Dept. of Forestry	Special Forest Warden	○	○	◐	●	●	◐[f]	◐[f]	◐[f]	○	●	
Dept. of Conservation & Recreation	Resource Manager	○	○	◐	◐	◐	○	○	○	○	◐[g]	
Dept. of Military Affairs	Forester	○	○	○	◐	●	○	○	○	○	○	
Road Maintenance, Construction, & Safety												
Dept. of Transportation	Transportation Operator	○	○	●	○	●	○	○	○	○	○	
Dept. of Transportation	Electrician	○	○	●	○	◐	○	○	○	○	○	
Dept. of Transportation	Safety Service Patroller	○	○	●	○	○	○	◐	○	○	◐[h]	
Dept. of Transportation	Construction Inspector	○	○	◐	○	◐	○	○	○	○	○	
Dept. of Transportation	Bridge Inspector	○	○	◐	○	○	○	○	○	○	○	

Legend

● Indicates occupation is at high risk for this factor (relative to other higher risk occupations), or fully satisfies criterion.

◐ Indicates occupation is at medium risk for this factor (relative to other higher risk occupations), or partially satisfies criterion.

○ Indicates occupation is at low risk for this factor (relative to other higher risk occupations), or does not satisfy criterion.

Notes

[a] - Emergency first responders include persons who have the duty to respond to fires, accident scenes, or emergency medical calls for service. Note that while law enforcement officers typically have first responder duties, some groups do not carry out a routine patrol function or carry police-band radios and so are unlikely to be dispatched as a first responder.

[b] – DOC probation officers, DOC surveillance officers, DJJ Probation Officers, DJJ correctional officers, and security positions at DMHMRSAS forensic facilities are not required to be DCJS certified but should be considered officers of a criminal justice agency or agency sub-unit.

[c] - All DMHMRSAS security officers are tasked with maintaining general order within agency facilities. Additionally, DMHMRSAS security officers at 3 of 10 mental health facilities and 2 of 5 training centers are sworn Conservators of the Peace. This status is not derived from a specific designation given in the *Code of Virginia* – appointments are made by a circuit court judge and are temporary (up to 4 years). Some DMHMRSAS security officers appointed as Conservators of the Peace have also been empowered as law enforcement officers by the appointing judge and are required to meet DCJS certification standards.

[d] - Most Direct Service Associates at DMHMRSAS facilities are not officially designated as security personnel. No nurses are designated as security personnel. However, as the principal patient caretakers, these employees have a professional duty to preserve general order within DMHMRSAS institutions by responding to and assisting others with de-escalating or physically subduing patients.

[e] - Some, but not all, of employees at DJJ halfway houses are security officers obligated to maintain general order within their institution.

[f] - Under the *Code of Virginia,* Special Forest Wardens are designated as fire fighters but this is not their full-time occupation. While SFWs regularly respond to wildfire situations they are rarely if ever required to perform a rescue. *The Code* also vests SFWs with forest-related law enforcement authorities and designates them as Conservators of the Peace, who are must meet minimum DCJS certification standards.

[g] - Some DCR resource managers are responsible for responding to wildfires on park properties. Officials said that wildfires on park lands are infrequent and typically less dangerous than private-land wildfires.

[h] - Safety Service Patrollers can be called to respond to the scene of car accidents and provide emergency assistance.

Source: JLARC staff analysis of State occupations.

Guidelines for Considering Changes to Enhanced Retirement Plan Membership

Indicators such as informal SPORS and VaLORS membership criteria and actual enhanced plan membership indicate that any employee being considered for enhanced benefits should show an elevated risk of job-related injury and be directly responsible for protecting the safety of others, especially members of the public. Based on the work conducted during this review, JLARC staff have compiled a set of guidelines that can be used in conjunction with the assessment presented Table D-2 to ascertain if a given occupation merits consideration for enhanced benefits.

Guideline 1: Employee Should Be at Elevated Risk of a Life-Threatening Injury due to Performance of Hazardous Duties. Employees who regularly perform hazardous duties are at elevated risk of suffering a severe or life-threatening injury in the course of performing their work. Because this risk can increase as an employee ages, it may be advisable to allow such employees to retire early. In Table D-2, each potentially higher risk occupation is scored based on five factors that indicate the degree of risk an employee experiences in carrying out their duties, relative to other higher-risk occupations. These risk factors are: (1) personal assault (deadly weapon), (2) personal assault (unarmed assailant), (3) motor vehicle accident, (4) fire-related incident, and (5) other job-related accident. To be considered for enhanced benefits an occupational group should show a relatively high level of risk in at least one category or a medium level of risk in several categories. The State's highest risk occupations will show relatively high levels of risk in multiple categories.

The five risk factors stated above were selected because they are the major drivers of employee deaths and injuries. Personal assaults, by armed or unarmed assailants, are criminal acts that carry the risk of death and devastating injury. Motor vehicle accidents are the leading cause of job-related deaths among State employees. Fire-related incidents and other job-related accidents involving heavy equipment, power tools, strenuous physical activity, or exposure to chemical or biologic pathogens can also result in life-threatening injury. Potential health risks associated with each occupation were not included in this analysis as these risks should not be addressed through the retirement system.

Guideline 2: Employee Should Be Responsible for Protecting Others. Employees responsible for protecting the safety of others may be less able to perform their duties as they age, thereby placing persons who depend on them – colleagues, clients, members of the public – at risk. It may therefore be advisable to allow such employees to retire early. In Table D-2, each occupation is scored based on (6) their obligation to maintain safety within a jurisdiction or institution, and (7) what impact, if any, employee actions are likely to have on the safety of others. To be considered for enhanced benefits an occupation group should show at least a medium-to-high score in both the "obligation" and "action" categories.

An obligation to maintain safety within a jurisdiction or institution indicates whether or not employees are duty-bound by a sworn oath of office or other professional obligation to respond to a dangerous situation which they themselves are not involved in, such as subduing a violent person who is threatening another person or venturing into a burning building to save a life. Employees who do not have an obligation to maintain safety, such as a non-custodial employee at a juvenile correctional center, may still regularly choose to intervene and protect the safety others. However, as they are not duty-bound to act, this measure does not reflect the likelihood of such employees choosing to take action.

While the "obligation" factor considers an employee's duty to act, the "action" factor considers the likelihood that an employee will actually be put in a situation in which they must take quick, decisive action that can have a direct impact on the safety of another. For example, while all State law enforcement officers have some obligation to maintain order, an officer who regularly arrests perpetrators of violent felony crimes is likely to have a greater direct impact on public safety than an officer who deals primarily with misdemeanor crimes and administrative infractions. In fact, the assessment in Table D-2 suggests that some employees who have an obligation to maintain safety may rarely, if ever, be required to take action to protect another person. Also, the action an employee takes must have an immediate and direct impact. For example, employees tasked with repairing or replacing road signs may improve general roadway safety but their actions do not have the same immediate and direct impact of a police officer who pulls over and arrests a reckless driver.

Guideline 3: Employee Should Perform a Public Safety Role. Employees responsible for protecting public safety may be less able to perform their duties as they age, thereby placing members of the general public at risk (as opposed to a colleague or member of a specific client group). This is significant, as current membership in State and local enhanced plans indicates that an employees' role in protecting public safety is a priority consideration. Eligibility consideration should therefore be focused on employees who perform a public safety role. State employees who perform public safety roles include (8) DCJS certified criminal justice officers who protect the public by managing convicted criminals and juvenile offenders, (9) DCJS certified law enforcement officers who protect the public through prevention and detection of crime, and (10) emergency first responders, who protect the public by responding to fires, vehicle accidents, and medical emergencies. To be considered for enhanced benefits an occupational group should show at least a medium-to-high score in one or more of these categories. If informal SPORS and VaLORS criteria are followed, only employees receiving a high score under the law enforcement officer category should be considered eligible.

Using the public safety model, all State law enforcement officers, DOC correctional officers, DJJ correctional officers, and some DMHMRSAS security officers meeting the minimum risk and responsibility criteria discussed above would be eligible for enhanced benefits. Firefighters employed under the Department of Military Affairs at the Fort Pickett Fire Department, all of whom are full-time, full-service fire and emergency services personnel, would also be eligible assuming the fire-related risks they face are determined to be sufficient. Of the law enforcement groups, investigators with DOC, DJJ, and State Lottery all have limited powers and authorities. For example, they are not obligated or authorized to stop a crime being perpetrated in their presence unless it directly relates to an authorized investigation. Two other groups would also merit consideration as public safety officers: DOF special forest wardens and probation officers at DOC and DJJ. However, each of these groups faces obstacles to membership. DOF special forest wardens are not full time firefighters and do not regularly perform rescues. DOC and DJJ probation officers have only a limited obligation to maintain order within the Commonwealth and their actions can rarely have a direct impact on another person's safety.

Changes to Enhanced Plan Membership Should Consider Recruiting and Retention Impact

Many State agencies employ persons in similar occupations performing similar work. Providing one group of State employees with enhanced retirement benefits can therefore have an unintended and detrimental impact on another. For example, there are two State agencies that hire probation officers: DOC and DJJ. Probation officers at DOC are provided with enhanced benefits while probation officers at DJJ are not. As both DJJ and DOC offer probation officers similar salaries, the difference in retirement benefits may have given DOC a competitive advantage over DJJ in recruiting and retention. A potential solution to this issue is to either include or exclude persons in similar occupations at different agencies from enhanced plan membership, provided that the occupation groups in question carry out similar responsibilities and experience similar risks. Additionally, no new group should be provided enhanced benefits without first considering if there are other State or local occupations that perform similar work, have similar responsibilities, and encounter similar job-related risks.

The different provisions of enhanced plans, such as those between SPORS and VaLORS, can also have a detrimental impact on recruiting and retention. For example, some VaLORS-covered agencies have reported difficulty recruiting new and experienced officers because new VaLORS members are not eligible for the hazardous duty supplement that SPORS and LEOS members receive.

Appendix E

Agency Responses

As a part of an extensive validation process, State agencies and other entities involved in a JLARC assessment are given the opportunity to comment on an exposure draft of the report. Appropriate technical corrections resulting from comments provided by these entities have been made in this version of the report. This appendix includes written responses from the Virginia Retirement System and the Department of Human Resource Management.

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Retirement
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Robert P. Schultze
Director

October 7, 2008

Mr. Philip A. Leone
Director
Joint Legislative Audit and Review Commission
General Assembly Building, Suite 1100
Richmond, VA 23219

Dear Phil:

Thank you for the opportunity to review the exposure draft of Review of State Employee Total Compensation, dated September 25, 2008. The staff at VRS believes the report is very well done and will be quite useful to members of the General Assembly. The retirement options, in particular, are clearly presented and well chosen to reflect an appropriate range of alternatives that the General Assembly will wish to consider. The report's content will add immeasurably to the quality of discourse on these important matters.

We did not ask the VRS actuary to analyze costs or express an opinion on the actuarial projections or cost analyses presented in the draft. However, with the exception of the COLA option (see below), the costs presented appear to be plausible and realistic. The report is particularly useful with its estimates of the timeframes over which the savings from each option would materialize.

We are surprised that the proposed COLA reduction (Option R2) could save so much money so quickly when it would only be applied prospectively to future retirees. We still have a cohort of about 140,000 retirees who would continue to receive the higher COLA formula for many years to come. The new COLA formula and its associated savings would only gradually take hold over many years as the new cohort grows and the old cohort declines in size. Savings would be further delayed as most members of the new cohort would not receive their first COLA under the new formula until 18 – 24 months following their retirement date. Yet the report projects annual savings of $54 million as early as 2013. Perhaps another review of this cost projection and its timeframe would be in order.

The discussion on Option R2 also suggests that the General Assembly consider exempting active employees within several years of retirement eligibility in order to avoid adversely affecting retirement plans already made. We also suggest that the General Assembly might consider this option to avoid a sudden surge in retirements of

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senior staff just prior to the new COLA's effective date. A sudden and unplanned loss of talent at state and local agencies could be disruptive to critical operations.

We have some concern about the role of the Director of VRS as a member of the proposed compensation advisory board. The VRS Board precludes the Director from advocating for benefit provisions and expects the Director to serve instead as an independent expert on retirement matters for both the executive and legislative branches. Membership on an executive branch board might create the perception that the VRS Director is to be an advocate for benefit provisions advanced by the Governor, thereby reducing the Director's credibility as an independent source of benefit information to the General Assembly.

The report also addresses disability costs incurred by the City of Virginia Beach and suggests that localities be allowed to establish managed disability programs somewhat like the VSDP program for state employees. Such legislation has been proposed and found unacceptable to the General Assembly and many localities. Perhaps JLARC should also consider less far reaching proposals that would modify certain features of the traditional disability plan currently in force. Local officials have, from time to time, suggested responsible modifications to the traditional plan which might serve to modernize the program and reduce costs.

Thanks again for the opportunity to comment on the exposure draft. Please know that VRS stands ready to assist JLARC and members of the General Assembly as the study leads to further inquiries.

Sincerely,

Robert P. Schultze
Director

COMMONWEALTH of VIRGINIA

Sara Redding Wilson
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October 7, 2008

Philip A. Leone, Director
Joint Legislative Audit and Review Commission
Suite 1100, General Assembly Building, Capitol Square
Richmond, Virginia 23219

Phil
Dear Mr. ~~Leone~~:

Thank you for the opportunity to comment on the Exposure Draft of your report "Review of State Employee Total Compensation," dated September 25, 2008. Employee compensation is of critical importance, not only to employees themselves, but to the citizens of the Commonwealth who depend on the services they provide. That is especially true when financial resources are strained, a situation the Commonwealth faces today.

My staff and I have enjoyed working with JLARC staff during the last two years while the study was being conducted. The report represents a comprehensive review of the large and complex total compensation program for Virginia state employees. In reviewing the draft, we found the approach logical and the findings reasonable. I hope that you and other state decision-makers find the comments below helpful.

TOTAL COMPENSATION

In the area of total compensation, employees' salaries and benefits are important to their health and welfare which, in turn, affect employees' productivity and the costs of providing services. For example, inadequate compensation may contribute to turnover, which may increase recruitment, training, and overtime costs. In an effective compensation program, salaries and benefits work together to help the state attract, retain, and motivate a high performing workforce.

We believe that the state's compensation program provides agencies with a variety of tools to help them meet their program objectives. Where staffing difficulties have persisted, funding limitations have usually been the major obstacle to addressing those problems.

Your report found that state salaries are, on average, at 92% of the market median and that state total compensation is 96% of the market median. DHRM survey findings in 2007 indicated a somewhat lower percentage of market in the 80-85% range. While we did not calculate the value of employee benefits in 2007, we acknowledge that the state's benefits package is more valuable than the benefits provided by many other employers. We understand that measuring market position is not an exact science. However, if the 96% figure becomes generally accepted as the current market position, it will become a frame of reference against which any future changes to our salary and benefits programs, as well as future market movement, will be measured.

Regarding the report's total compensation recommendations, we support the idea of providing employees with total compensation statements and with using total compensation information to aid recruitment efforts. DHRM has wanted to implement this recommendation for some time, but it has been delayed due to limited staff resources. We also support the idea of incorporating workforce planning into the state's overall strategic planning and budgeting activities.

We do not support the creation of a formal compensation advisory board. DPB, VRS, and DHRM, along with money committee staff, already perform this function. Even if an advisory board is created, total compensation decisions will remain fragmented as long as human resource management and related financial functions remain in separate agencies and cabinets. This recommendation adds another layer to the decision making process that does not add value.

SALARIES

In the chapter on state salaries, the JLARC report recommends that DHRM work with state agencies to develop more structure and guidance for the job classification process. We concur with this recommendation. In some cases, agencies have developed such structures already, and DHRM has provided assistance in their doing so. However, there are other agencies where classification and salary administration are less structured, and more structure is needed.

There is considerable discussion in the report of pay for purpose, whereby funds would be targeted to jobs or groups of jobs whose salaries are less competitive and staffing problems have been documented. We view these proposals as a more formalized approach to the budget request process that is currently in place. We support the formalized approach. However, we believe that the overall competitiveness of state salaries and the ability of all state employees to meet their basic financial obligations must be given the highest priority. Targeted funds should continue to be used to supplement general, performance-based increases in situations where severe staffing problems exist.

HEALTH BENEFITS

We agree with your findings that the health benefits program is very important in recruiting and retaining employees as well as maintaining productivity. We also agree that the costs associated with the program are rising and are a cause for concern. At the same time, we noted in your report that 15% of employees reported that they neglected care or medications during the past year due to the costs involved. While consumer education, such as that offered through CommonHealth and vendor-specific programs, may assist employees in this area, increases in costs to employees may have an effect on their ability to pay for services, on their health, and on the competitiveness of the state's total compensation package.

We favor maintaining consistent employee/employer cost-sharing, adjusting out-of-pocket cost as necessary, while maintaining the insurance nature of the program, to protect employees and their families from unforeseen and uncontrollable risk. We believe that plan design can be refined to maximize its effectiveness, while controlling costs and without affecting the 96% of market total compensation position.

RETIREMENT

In the chapter on retirement, JLARC recommends considering the use of employee contributions, reduced cost of living adjustments for retirees, an increase in the age for unreduced retirement, and, possibly, alternative retirement plans. As with health insurance, passing increasing costs to employees may be necessary, but such changes will adversely affect employees financially and will reduce the state's competitiveness.

An increase in the age for unreduced retirement is probably the best among these options, because workers are living and working longer than in the past and because state agencies need their knowledge and experience. At the same time, employees have been led to expect retirement at a relatively early age as a result of early-out programs, reductions in the minimum retirement age, and increasing work demands, which lead to employee burnout. We also noted that the Code definition for normal retirement age is 65, which does not reflect current plan provisions.

We are concerned that a reduction in the cost of living adjustment for retirees might make it more difficult for many employees to afford retirement or may result in a higher risk of inadequate income replacement over the lifetime of those who do retire. This is a real concern as the rate of inflation appears to be rising now.

We agree that the VRS plan should be funded at a level that is actuarially sound. This is essential to the long-term ability of the plan to provide benefits and to avoid a funding crisis such as the Social Security program now faces.

We endorse continuation of the defined benefit retirement program as the most effective means to provide loyal employees with a dependable retirement benefit. While other plan options might reduce future costs, they would increase administrative costs and erode the 96% total compensation market position. If costs savings are considered essential, we would prefer that employee contributions be restored at some level rather than abandonment of the defined benefit plan. It should be noted that the current plan does not benefit employees who work for state agencies for less than five years. A defined contribution program, for example, would benefit these employees, but in this case, at a higher cost to the Commonwealth.

LEAVE

We agree that the state's leave programs are competitive. However, the finding that 20% of employees cannot use all of the leave that they are provided harms employee morale and productivity.

The option to allow employees to sell some of their annual (vacation) leave each year would be an effective way to reduce an unfunded, long-term liability. This liability often equates to approximately two months of salary for retiring employees. Employees use the accrued leave as a savings plan, and will need to be educated on the long-term impact of their decisions.

BILLS

I also want to comment on the Bills noted at the beginning of Appendix B, relating to phased retirement. We support phased retirement as an effective way to reduce salary costs while keeping experienced and knowledgeable workers on the job. Current IRS regulations permit workers 62 year of age or older to draw retirement benefits and continue working for the same employer. We would like to see this option made available to all state workers 62 or older.

SUMMARY

Employee total compensation is an issue that will grow in importance as we recruit the next generation of employees. Again, thank you for this opportunity to comment. I will be happy to discuss these comments with you further and answer any questions that you have. We look forward to continuing cooperation with you and the JLARC staff as we work to continuously improve the total compensation program of the Commonwealth.

Sincerely,

Sara

Sara Redding Wilson

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