The Florida Senate

Interim Project Report 00-53 *September 1999*

Committee on Governmental Oversight and Productivity Senator Daniel Webster, Chairman

EMPLOYEE INCENTIVES FOR PERFORMANCE

SUMMARY

During the 1999 Session, the Senate passed a bill (CS/SBs 350 and 364) which provided for the development of an alternative benefit plan to Social Security coverage for casual, temporary, and seasonal employees. Under Florida law, such employees are paid from the Other Personal Services (OPS) budget categories. The proposed plan also would have tax-sheltered annual and sick leave payments made to state employees from Social Security and Medicare taxes. The bill further directed that these unobligated employer payroll tax contributions would be directed to the creation of an incentive fund for agencies meeting or exceeding their performance-based budget (PB²) standards.

This project discusses the advantages and disadvantages of these two approaches; suggests implementation of the OPS alternative for state agencies with prospectively hired employees, but cautions against too quick an implementation within the State University System because of unique utilization of OPS employment; and suggests implementation of the annual and sick leave tax sheltering plan for full- and part-time state employees.

BACKGROUND

Performance-Based Budgeting -- In 1994, the Florida Legislature passed a budget reform effort entitled Performance-Based Program Budgeting (PB²). The PB² process begins with the Legislature specifying in the *General Appropriations Act* the level of services each participating state program is expected to provide with the resources it receives.[1] Thereafter, program results are tracked, and this information is used by the Legislature to make future policy and appropriations decisions.

In the event a program meets or exceeds its expected level of service, Florida statute permits the Legislature to award incentives. Conversely, if a program fails to meet expectations, the Legislature may sanction the program with disincentives. These incentives and disincentives may be financial, such as increases or decreases in funding, or non-financial, such as increases or decreases in budget flexibility.

Since 1994, the Legislature has appropriated more than $18 million in performance-based incentive funds for programs in numerous state entities including the public school system, community colleges, universities, and the Florida Department of Law Enforcement. Some of these have focused on policy incentives which target a more efficient use of the capital plant by speeding the time to university graduation.

OPS Employees -- Persons employed to perform time-limited duties are classified as OPS, except that employees for the Board of Regents, Florida School for the Deaf and Blind, and Division of Blind Services are exempted from the OPS classification.[2] OPS employees are limited to working a maximum of 1,040 hours within a twelve-month period. Extensions of this time maximum may be granted by agency heads and this maximum does not apply to board members, consultants, seasonal employees, institutional clients employed as part of their rehabilitation, and degree-seeking students in secondary or post-secondary programs.

Based on data supplied by the Comptroller's Office, 37,069 OPS employees were on the state's payroll in August 1999. About 73%, or 27,115, of these employees work in the State University System (SUS), while the remaining 27% (9,954) of employees work for other state agencies. The number of OPS employees in Florida varies in any given month due to the temporary and seasonal nature of the employment. For example, the number of OPS employees in the university system

[1] Section 216.053, F.S.

[2] Section 110.131, F.S.

increases between the months of September and May when the majority of students are in school. In calendar year 1998, the state accounting system reported a wage base of more than $490 million for all OPS employees.

Unlike other state employees in established positions, OPS employees are not provided any employer-sponsored health or life insurance, sick or annual leave, nor Florida Retirement System (FRS) contributions. They are also precluded from represented status with collective bargaining agents. They are permitted to participate in the Deferred Compensation Program for the sheltering of their salaries from federal taxes. Prior to 1991, Florida did not provide its temporary employees with Social Security benefits. In 1990, however, Congress amended Section 31.3121 of the Internal Revenue Code (IRC) to require that most public sector employees who do not participate in an employer-provided retirement plan be covered by Social Security or an equivalent plan. Accordingly, in July of 1991, Florida initiated Social Security coverage.

Under the Social Security Act, participants are entitled to retirement, disability, and death (survivors') benefits. To qualify for these benefits, participants receive credit for each calendar quarter of covered employment during which the employee has earned at least $740. Retirement benefit entitlement occurs when 40 credits are earned. Unreduced benefit retirement occurs at age 65, with the level rising to age 67 in the year 2003, depending on the participant's birth year. Disability benefit entitlement occurs when 6 to 40 credits have been earned, depending upon the age at which the disability is suffered. Death benefits are payable to the dependent children of an employee who earned 6 credits during the 3 years before his or her death, and may also be payable to other surviving family members based upon the earned credits of the deceased.

The tax for Social Security is commonly referred to as the FICA tax; however, FICA actually consists of both Social Security and Medicare contributions. Both the state and the OPS employee each contribute 7.65% of total wages to FICA. The Social Security portion is 6.2% of the first $72,600 in OPS compensation, and the Medicare portion is 1.45%. In calendar year 1998, the state's 6.2% contribution for its covered OPS employees in the SUS was more than $10 million, and for its OPS employees in non-SUS agencies was $6.5 million.

Annual/Sick Leave Payments -- State employees in full- and part-time established positions earn sick and annual leave. The amount earned depends upon the employee's length of service and classification/pay plan. When the employee terminates state employment or retires, he or she is entitled to receive payment for a certain amount of accrued leave. Career Service employees may receive payment for up to 240 hours of accrued annual leave and for up to 480 hours of sick leave. Other exempt and management employees may be paid for up to 480 hours annual leave and 480 hours sick leave.

The employee's entitlement to the accrued leave payment occurs on the last day of employment, except that employees who choose the Deferred Retirement Option Plan (DROP) receive payment for annual leave on the date of program entry, and receive payment for sick leave when the DROP period is completed. The amount of annual leave paid to an employee choosing DROP may be used in calculating the employee's average final compensation for FRS purposes.

Leave payments are treated like income and, thus, are subject to federal income tax and to the 7.65% in FICA taxes. Both the state and employee are each responsible for paying 7.65% in Federal Insurance Contributions Act (FICA) contributions. Terminating employees, however, may choose to tax shelter their leave payment from income taxes by placing it in their deferred compensation account.

Data supplied by the Comptroller's Office reported that the state paid nearly $44 million for annual leave and more than $12 million for sick leave in calendar year 1998.

METHODOLOGY

The methodology for this report included conducting meetings with the Department of Management Services, the Division of Retirement, and affected investment providers. Additionally, staff researched applicable statutes and case law, and reviewed the following reports: "The Alternative OPS FICA Program" by the State University System Task Force, 1995; The Actuarial Special Study 94-3 by Milliman & Robertson, Inc. (M&R), 1994; and "Pension Coverage for Temporary Employees" by the Florida House of Representatives Employee and Management Relations Committee, 1994.

FINDINGS

Social Security Alternatives for OPS Employees -- Social Security coverage for OPS employees is not Florida's only option for compliance with section 31.3121, IRC. Instead, the section permits public employers to establish an alternative plan for OPS employees if the plan provides retirement benefits comparable to Social Security. The following discussion addresses only an alternative plan which would result in eliminating the state's OPS Social Security expenditures. Other plans which could reduce, rather than eliminate the state's Social Security contributions might be possible; however, as indicated in M&R's Actuarial Special Study 94-3 such plans are untested and administratively complicated.

Section 31.3121, IRC, permits the implementation of an employee paid pre-tax defined contribution plan. In order to comply with the IRC, the contribution to the account must be at least 7.5% of gross pay. Furthermore, the account must earn a reasonable rate of interest, and the employee must be fully vested on the first day of employment. Currently, multiple private provider companies offer IRC compliant, employee paid pre-tax defined contribution plans, and more than 50 Florida counties and community colleges have these plans in operation.

If the state were to implement this type of plan, the obvious benefit would be the state's avoidance of its current 6.2% Social Security contribution. In 1998, the state could have saved $6.5 million in Social Security payments for agency OPS employees, and could have saved more than $10 million in payments for university system employees. Moreover, this type of plan will have an insignificant impact on the employee's take home pay because the contribution will be made with pre-tax dollars. OPS employees in the higher tax brackets may realize a slight increase in take home pay. For example, an OPS employee in the 28% tax bracket who earned $1000 would take home $658 after the 6.2% Social Security contribution and income taxes, versus take home pay of $666 after the pre-tax 7.5% defined contribution and income taxes. OPS employees in the lower tax brackets may have a slight decrease in pay. For example, an OPS employee in the 15% tax bracket who earned $1,000 would take home $788 after the 6.2% Social Security contribution and income taxes, versus take home pay of $786 after the pre-tax 7.5% defined contribution and income taxes.

Whether a pre-tax defined contribution plan would be advantageous to the OPS employee in the long run varies greatly depending upon each employee's individual circumstances and choices. Generally, OPS employment is short-term, and in most cases OPS employees will vest in Social Security through other, more regular employment. Consequently, for this type of employee, the OPS defined contribution plan will be a supplemental investment. On the other hand, if the OPS employee never vests in Social Security, and continually withdraws his or her defined contribution plan account balance at the termination of each OPS employment, the alternative defined contribution plan will not provide him or her with any retirement security. Furthermore, for the employee who works several jobs seasonally, the enrollment and withdrawal from each employment would also be administratively complex and inefficient.

Tax Sheltering of Annual/Sick Leave Payments-- When the state issues payment for annual and/or sick leave to an employee leaving state employment, both the state and the employee must each contribute 7.65% of the gross payment to FICA taxes. Under the federal tax code, however, an employee is permitted to place these monies in a tax sheltering plan which would enable both the state and employee to permanently avoid the FICA contribution, and would enable the employee to postpone payment of income taxes until the money is withdrawn. Per federal law, the amount of money which may be placed into such a plan is limited to 20% of the employee's annual compensation, not to exceed $30,000. Currently, multiple private provider companies offer such tax sheltering plans, and more than 50 Florida counties and community colleges have these plans in operation. An interesting phenomenon resulting from the enrollment of education-based employers in this program is that they are realizing a payroll cost savings that may not be reflected in the funding formula used by the Legislature for their organizations.

The clear advantage to the state if it were to require employees to tax shelter annual and sick leave payments is that the state would avoid its current 7.65% FICA contribution. For example, had the program been operational in 1998, the state potentially could have saved some $4 million. Likewise, the plan would benefit the employee by saving the FICA tax, and by also enabling the employee to postpone paying income taxes on the monies in a lower income year. The only disadvantage to the tax sheltering plan would be to employees who wish to immediately use their leave payment.

RECOMMENDATIONS

1. Enacting legislation which requires the alternative benefits plan to Social Security for OPS employees to be implemented is a viable opportunity for the state to save millions of dollars in OPS Social Security contributions. However, it appears that this plan should only be made

compulsory for non-SUS agencies with OPS personnel. Due to the uniquely variable employment history of OPS within the SUS, the alternative plan may be administratively inefficient within that employment context. Thus, it may be a better course of action to make this plan optional for the SUS following further study by the Board of Regents and the Council of University Presidents.

2. Enacting legislation which requires implementation of the plan which will tax shelter leave payments likewise appears to be a viable opportunity for the state to save millions of dollars in FICA payments for annual and sick leave payout.

3. There is a clear advantage to the use of these new programs as a means of creating a performance-based fund for innovation and excellence. The pooling of these saved dollars, which otherwise would have been deposited in the federal treasury, can give agency managers a tangible expectation of pay for performance when legislatively mandated goals are attained.

4. The Legislature needs to decide whether the new programs should be voluntary or mandatory with participating employees. While this issue impacts the scale of the savings, it also affects what relationship these programs will have upon the use of the existing deferred compensation program, which is subject to FICA taxes, as a depository for OPS contributions and excess terminal leave.

5. Sufficient lead time needs to be given to the Department of Management Services and the Board of Regents to undertake the required proposal development and to notify the affected labor organizations which represent state employees.

COMMITTEE(S) INVOLVED IN REPORT ***(Contact first committee for more information.)***
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MEMBER OVERSIGHT
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