UC BERKELEY LABOR CENTER

October 2009

UC BERKELEY CENTER FOR LABOR RESEARCH AND EDUCATION

POLICY BRIEF

THE HIGH COST OF FURLOUGHS

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EXECUTIVE SUMMARY

In February 2009, Governor Arnold Schwarzenegger required California state workers to take two furlough days a month. The furlough was increased to three days a month for Fiscal Year 2009– 2010. Thirty-six furlough days a year is equivalent to a 13.8 percent reduction in salary. The furloughs were put in place as part of a broader response to California's severe budget crisis. Drawing on standard economic theory and empirical research we find that the furloughs are a particularly inefficient method of addressing the budget deficit.

Based on new data from Office of the State Controller on actual savings from the furloughs since February 2009, we estimate a reduction in wages and benefits of $2.01 billion for 193,000 workers over the course of the year. Accounting for the share of furloughs that impact workers who are not on the General Fund, lost revenue, and increased costs due to the furlough program, the net savings to the General Fund for FY 09–10 is estimated to be just $738 million. The FY 09–10 furloughs will further result in a loss of $503 million over the subsequent years,[i] leaving a net savings of $236 million to the General Fund.

If all workers were subject to one rather than three furlough days as agreed to by Service Employees International Union Local 1000, which represents 95,000 of the 193,000 workers subject to furloughs, the savings to the state in FY 09–10 would be $341 million. Given a much smaller drop in revenue in the subsequent years from a single monthly furlough day, the medium-term net savings to the General Fund would be $256 million, or $20 million more, with a single furlough day a month than with the current three days.

In addition, we have found through our analysis that:

- The furloughs create a significant hardship for workers. The salary reduction is equivalent to losing more than seven weeks of pay a year. A pay reduction of this magnitude can be expected to result in lower employee morale and increased stress, both of which are associated with reduced productivity and greater work errors. Wage reductions may also lead to turnover of more highly productive workers.

- The total pay reduction without benefits from the furloughs is projected to be $1.63 billion in 2009–2010. Taking into account taxes and employee savings, this is expected to reduce employee spending by $1.24 billion over the course of the year. The reduction in spending will have a multiplier effect in the economies of cities and counties with large numbers of state workers, resulting in a loss of private sector jobs and a potential increase in home foreclosures.

- Workers included in the furloughs are not all paid through the state General Fund. Of the $2.01 billion reduction in spending for salary and benefits, an estimated 57.7 percent comes from general funds and 42.3 percent from federal and special funds. Furloughs of workers on federal funds represent a straight loss of income to the state.

- The furloughs include workers paid through federal funds who perform roles in qualifying California residents for federal support. Any slowdown in processing or qualifying applicants will result in an additional loss of income for California residents.

- Furloughs of workers in revenue-generating departments like the Franchise Tax Board and the proportional reduction in funds to the Board of Equalization are projected to result in a loss of $363 million in tax collections in FY 09–10 and $366 million in the subsequent two years. In addition, licensing bureaus have reported increased backlogs, which will result in delayed revenue into special funds.

- The furloughs will result in a projected reduction in payments to CalPERS of approximately $299 million in FY 09–10, while benefits are maintained whole. In effect, the state is borrowing this money from CalPERS. The funds will be paid back—with interest—through an automatic adjustment in the formula for state payments to the fund, pushing the costs to subsequent years.

- Disruptions of state services have an impact on the broader economy. This includes delays in business licensing, longer waiting periods for public services, and traffic disruptions from the furloughs of Caltrans workers. Each of these exacts a cost on business operations in the state.

- For every dollar in reduced spending from furloughs, the state saves approximately 37 cents for the General Fund for FY 09–10; this falls to 12 cents when losses in subsequent years are taken into account.

The state should restrict furloughs to non-revenue generating departments that are paid for out of the General Fund. In addition, the state would greatly reduce the adverse impacts of the furloughs by restricting them to a single day and raising revenue to cover the difference. Depending on how the revenue was generated, such an approach would have a significantly smaller impact on jobs and the California economy than the current approach.

THE STATE FURLOUGH PROGRAM

Furloughs of California state workers were initially put into effect in February 2009 in response to the state budget crisis. The program started with two mandatory furlough days a month. No distinction was made between departments and positions funded by the General Fund, special funds (which are revenue-generating and self-supporting), or the federal government. Departments were required to furlough workers the first and third Fridays of the month. Some departments were given leeway to allow workers to use the furlough days at their own discretion over a 31-month period.

In February 2009, the Service Employees International Union Local 1000, which represents 95,000 of the 193,000 workers covered under the furlough program, negotiated a contract with the Governor for FY 09–10 which would have included a single monthly furlough day. Though the contract was ratified by the local's members, it was later rejected by the Governor. In July 2009 the Governor instituted a third monthly furlough day. The furloughs have lead to multiple lawsuits against the state. In September 2009 the San Francisco Superior Court tentatively ruled that the furlough of 6,200 State Compensation Insurance Fund workers was illegal and ordered the state to pay back wages with interest.[ii] The state is appealing the ruling. Officers of the California Highway Patrol (CHP) were exempted by the Governor from the furloughs; workers for the CHP 911 system were exempted in August 2009.[iii]

FURLOUGHS AND ECONOMIC THEORY

Economists have long studied the fact that wage reductions are rare in a recession. In explaining wage rigidity, economists argue that reducing wages may lead to a loss in productivity that exceeds the savings from the wage reduction. The loss in productivity comes from three major sources. First, wage reductions decrease employee morale, which impacts worker effort on the job. Second, wage reductions lead to greater turnover, which increases costs for training and hiring new workers. Third, employers are most likely to lose highly productive workers that have greater opportunities for outside advancement and find it more difficult to attract such workers in the future.[iv, v]

While furloughs are officially reductions in work hours, salaried workers with a stable schedule are likely to experience sizable furloughs as pay cuts. A furlough of three days a month is equivalent to a nearly 14 percent reduction in earnings, an annualized loss of more than seven weeks of pay. This can be expected to place significant stress on workers and reduced concentration on the job.

Proponents of furloughs have argued that workers can become more productive if the reduction in work hours is absorbed by less slack time. There is evidence from Europe that small reductions in work hours can lead to greater productivity. It is important to note, however, that in each of the cases studied the reduction in work hours was accompanied by a pay increase that left the workers' earnings at or above their prior level.[vi] Had the collective bargaining agreement for one furlough day a month been followed, it is possible that this would have been the outcome. There is likely to be a significant difference in morale and work effort impacts with a collectively bargained agreement that workers see as a way to prevent layoffs than with furloughs imposed without such an agreement. To the degree that furlough days are taken in lieu of vacation days, productivity might be maintained while the cost for vacation days is passed onto subsequent years. As the amount of furlough time increases, however, the share of furlough days traded off for vacation time will decrease.

Calculating the Budgetary Impacts of the Furloughs

In order to assess the budgetary impact of the furloughs, it is important to account for both savings and costs to the General Fund that result from the program. Using data from the Office of the State Controller, we first calculated the total budget savings and then the savings to the General Fund from the furloughs. We then subtracted estimates of lost state income taxes from state employees; reduced revenue collection due to cuts to the Franchise Tax Board and the Board of Equalization, the state's two primary collection agencies; and the funds needed to maintain retirement benefits despite the reduced payments to CalPERs caused by the furloughs. Putting this together, we arrive at an estimate of the short and medium turn costs and benefits of the furlough days.

Adding up the Savings

Taking the difference between payroll costs in January 2009 prior to the initial furloughs and the payroll costs in each of the subsequent six months after the furloughs were implemented, and also accounting for changes in employment, the Controller's office estimates the reduction in payroll cost from two furlough days between February and June at $88 million a month and $132 million a month in beginning in July, when the third furlough day went into effect. Factoring in hourly workers, the Controller's office estimates a total of $136 million per month in salary reductions due to the furloughs, or $1.632 billion in FY 09–10.

We reach a similar result by starting with the total payroll of salaried workers on the furlough program in July 2009: $837,752,163. Three furlough days a month are the equivalent of 13.8 percent of income. This implies a total monthly payroll for those same workers in the absence of a furlough of $971,870,259 a month, a difference of $134 million.

If we factor in the state share of Social Security, Medicare, and retirement payments to CalPERS, we come to a total of $2.01 billion in state savings for FY 09–10. Our calculation, which is based on actual salary savings to date, is slightly lower than the savings projection from the Governor's 2009-2010 budget of $2.2 billion.

A three-day furlough in FY 09–10 is projected to reduce state spending by $2.01 billion: $1.63 billion in wages and $381 million in reduced benefits. The California Department of Finance projects that the General Fund will see 57.7 percent of the savings from furloughs while the remaining 42.3 percent will come from a combination of federal funds and special funds. This means that of the $2.01 billion in total spending reductions, $1.16 billion would be cut from the General Fund.

Table 1. Reduced Wage and Benefit Spending, July 2009 to June 2010, in millions

Wages	1,632
SSN/Medicare	81
CalPERS	299
TOTAL	2,012

Source: Office of the State Controller

Subtracting the Losses

The furloughs are projected to result in losses of state tax revenue that will offset a significant part of the savings. The pay reduction will result directly in a loss of $60 million in state income tax payments.[vii] The Franchise Tax Board (FTB) estimates that the loss of work time for audits due to furloughs will result in an additional loss or delay of $231 million in income tax collections in FY 09–10.[viii] It further projects a loss or delay of $211 million in FY 10–11 and $264 million in FY 11–12 to the General Fund; $54 million of this would be recouped in subsequent years. Adding up the lost income taxes and adjusting for the collection of delayed funds, the General Fund will see a total loss of $652 million.

While the Board of Equalization (BOE) is not required to furlough its workers, it is taking a proportional budget cut of $24 million. It estimates that these cuts will result in a loss or delay of a $264 million in sales taxes and fees, of which $156 million would have gone to the General Fund.[ix] If we assume that the delayed revenue to the BOE is paid back over two years, it would translate into a total loss of General Fund revenue of $423 million in FY 09–10 and $312 million over the following years, for a total loss of $735 million.

Taking all of the lost revenue into account, the net savings to the General Fund for FY 09–10 drops to $738 million. The actual savings are likely to be even lower, as this does not account for subsequent-year revenue losses, additional costs to the General Fund from reductions in fee collections by other departments, lawsuits against the furloughs, and the cost of hiring outside contract workers to make up for time lost to furloughs.

In addition to these losses, the state is also incurring obligations to the CalPERS. The state makes payments to CalPERS for benefits on a percentage basis of salaries. The furloughs will result in an estimated $299 million loss in revenue to CalPERS in FY 09–10 without any corresponding reduction in benefit obligations. The state is, in effect, borrowing the funds for one year from CalPERS. The following year, the benefit payment rate is automatically adjusted to cover the obligations, creating an additional $173 million obligation for the General Fund, with the balance charged to special funds. Delay in payment to CalPERS will reduce income investments for the fund and correspondingly increase the amount owed to CalPERS, as the “interest rate” on the loan will then be equal to the average earnings by the fund in the market. Using a conservative assumption of 4 percent earnings over five years, this adds an additional $18 million cost to the General Fund in the out years, bringing the total to $191 million. CalPERS is also suing the state over furloughs of its members, arguing that the furloughs will negatively impact their ability to manage their funds for maximum return on investment.[x] To the degree that the furloughs reduce the return to CalPERS, the state would likewise be required to make up the difference in future years through an adjustment in the payroll rate paid to the fund.

Taking the $312 million in net lost General Fund revenues in the out years, and the $191 million in payments required to keep CalPERS whole, the total cost to the General Fund over the subsequent years would be $503 million. This leaves a balance in savings to the General Fund over a three-year period from one year of furloughs of $236 million (Table 2).

Table 2. General Fund Impact of Monthly Furloughs of Three Days and One Day, in millions

	Three Days	One Day
Total Wage and Benefit Cut	$2,013	$671
General Fund Wage and Benefits	1,161	387
FY 2009-2010		
Reduced Tax Collections	(363)	(26)
Reduced Employee State Tax Obligations	(60)	(20)
Sub-Total	(423)	(46)
Total General Fund Savings	738	341
Out Years		
Reduced Tax Collections	(475)	(33)
Collection of Delayed Tax Revenue	163	8
Repayment to CalPERS	(191)	(60)
Sub-Total	(503)	(85)
Total Savings to General Fund	***236***	***256***

Furloughs and the Broader Economy

Whether imposed on employees paid from state, federal, or special funds, furloughs impact the broader economy in multiple ways. First, any reduction in pay is a reduction in spending in the local economy and will have a multiplier effect, resulting in private sector job loss and subsequent loss of tax revenues. These effects cannot be taken in isolation but must be compared to other methods of reducing the budget gap, such as alternative cuts or increased revenues.

Furloughs of workers paid by federal funds additionally impact the economy through lost wages and loss of federal funds for services, further reducing spending in the local economy. Two examples of the latter are workers who review disabled individuals' applications for Supplemental Social Security Insurance (SSI) and Unemployment Insurance judges. In both cases furloughs result in both a loss of wages to the state and a loss of federally paid benefits to California citizens. Federal officials projected that furloughs of SSI workers could result in a delay of $15 million in disability payments to 53,000 Californians.[xi]

Another set of economic impacts will come from disruptions in public services. Longer lines will result in lost work and leisure time. Furloughs in business licensing agencies can be expected to increase the wait periods for a wide range of licenses necessary for firms to conduct business and individuals to work.

Reduction in hours and worsening morale can impact service in thousands of tiny ways. The Department of Motor Vehicles reports that the share of customers with wait times over two hours increased 22 fold.[xii] As the DMV is only open during the work week, the delay in services compounds the impact on business. Similar analysis could be done of each department facing furloughs. In one example, a spill of wine cork lubricant in Santa Rosa tied up traffic for twelve hours in June 2009. The spill took place on "furlough Friday" and Caltrans did not have the personnel to respond in a timely manner.[xiii]

Alternatives

California is in a severe budget crisis. The recent budget cuts will significantly reduce a wide range of vital public service in the state. Further cuts would be extremely difficult to find. Layoffs would have other negative consequences for the state; indeed, furloughs are generally used by state and local governments as a way to avoid layoffs through shared sacrifice.

If the state were to institute a single furlough day, as agreed to with SEIU Local 1000, the Franchise Tax Board estimates that its loss in revenue would fall to $50 million over the same three-year period. If we assume that an equal share of the BOE losses would be realized from a single furlough day in FY 09–10, total savings to the General Fund with a single monthly furlough day would be $256 million, or $20 million more than a three-day furlough.

Another alternative that could be pursued separately or in combination with the option discussed above would be to restrict furloughs to departments that are both funded out of the General Fund and are not revenue producing. This would significantly reduce the economic impacts and out-year costs to the General Fund.

The state would be better off raising revenue to make up for the cash flow difference between one and three furlough days. California's two-thirds requirement to raise taxes makes this difficult. Fees, however, may be raised by a majority vote. The multiplier effect of fee or tax increases will depend on the source: for example, the oil severance tax proposed by the legislature earlier this year would have a very small impact on the state economy compared to the budget cuts, but the 6 percent tax is estimated to bring in $960 million in revenue in FY 09–10, far more than the savings from the furlough program.[xiv] An increase in the sales tax or an across-the-board increase in the income tax rates would be similar in economic effect to a cut in pay for state workers, though because it is shared more broadly would be less likely to result in major individual disruptions.

Conclusion

The furloughs currently in effect in the California State Government are a particularly inefficient form of budget savings. The General Fund saves less than 37 cents for each dollar cut in wages and benefits for the current fiscal year, and 11 cents when losses in subsequent years are factored in. The negative impacts on the state and state workers from the furloughs would far outweigh the economic impacts of raising a similar amount through increased fees or taxes.

Endnotes

[i] The losses would be heavily concentrated in the next two years.

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[v] Campbell, Carl M, III & Kamlani, Kunal S. (1997, August). The reasons for wage rigidity: evidence from a survey of firms. *The Quarterly Journal of Economics*, *112*, (3), 759-89.

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[xii] California Department of Motor Vehicles, "3-Day Furlough Impacts," Prepared for the California Department of Finance, August, 2009.

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