Arizona
HUMAN RESOURCES

State of Arizona
Advisory Recommendation

Janet Napolitano
Governor

2008

William Bell
Director, Dept. of Administration

JANET NAPOLITANO
Governor

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ARIZONA DEPARTMENT OF ADMINISTRATION

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September 2008

The Honorable Janet Napolitano
Governor, State of Arizona
The Honorable Tim Bee
President, Arizona State Senate
The Honorable James Weiers
Speaker, Arizona House of Representatives
1700 West Washington
Phoenix, Arizona 85007

Dear Governor Napolitano, President Bee and Speaker Weiers:

On behalf of all state employees, we recognize and appreciate the efforts of the Governor and the Legislature to provide funding for salary adjustments during recent years. The salary increases in 2006 and 2007 significantly reduced the gap between our state employee salaries and the market. The state had been over 20% behind the market; a huge discrepancy that was significantly affecting the ability to attract and retain quality talent. After the increase in 2007, that gap had been closed to almost 7%, and the state finally seemed to be within striking distance of our long elusive goal to be within 5% of the market.

Unfortunately, the economy at both the national and local levels suffered severe setbacks. A hiring freeze was implemented and agency budgets were reduced along with other measures necessary to balance the state's budget. These conditions precluded providing increases to salaries in 2008. Subsequently the state lost ground to the prevailing job market and salaries are currently estimated to be 9.5% behind the market.

The following recommendation provides an objective assessment of the job market and the average salaries paid to Arizona state workers. However, the Department of Administration understands and appreciates the realities of the continuing economic situation of the State's budget. Therefore, a specific salary increase is not included in this year's recommendation. We are committed; however, to partner with the budget offices to investigate strategies and specific options as more information about the State's fiscal status becomes available.

We hope that the Annual Advisory Recommendation will provide the information you need when making decisions regarding Arizona State government and its employees' compensation.

Sincerely,

William Bell
Director

2008 Advisory Recommendation on State Employee Salaries

Every September, the Arizona Department of Administration (ADOA) provides an Annual Advisory Recommendation to the Governor and the Legislature pursuant to A.R.S. §41-763.01. This document provides an analysis of the state's current compensation levels compared to other public and private sector employers, and a review of the critical factors that must be considered when reviewing compensation strategies. These factors include turnover rates, retirement projections, impacts to the labor market, and projected market movement. The report concludes with a recommendation that sets a strategic direction to ensure the state remains competitive with other employers and attracts and retains a competent, productive, and satisfied work force.

> *This report reflects the current status of Arizona State employee compensation as it relates to market conditions at the end of Fiscal Year 2008. The guidelines contained herein are provided as a resource to guide statewide budget considerations during the preparation of the Fiscal Year 2010 budget.*

METHODOLOGY

The improvements to the report methodology introduced last year have been retained and enhanced in this current report. We retained an increased number of salary surveys used to compare salaries to the market, and enhanced the number of benchmark jobs (and the number of employees in those jobs) that were used in the market comparisons. We also continued using state employees' base salary combined with performance pay as the basis of comparison with the market. In the past, only base salaries were used.

HISTORY OF COMPENSATION

Over the past several years, the state has implemented a number of different strategies to adjust employee salaries. These strategies included general salary adjustments, merit adjustments, special market adjustments, and other miscellaneous adjustments specifically targeted by the legislature. However, there have also been years where no salary adjustments were funded.

In 2005, the Department of Administration recommended a 5-year plan to bring employee salaries to within 5% of the prevailing job market. The plan developed in 2005 was used to guide the development of the FY 2007 budget, a budget that included an appropriation of a flat dollar amount ($1,650) to increase employee's base salary, and the introduction of a pay practice for Arizona state government employees called "performance pay". Performance pay is available to state employees if the governmental unit meets or exceeds prescribed performance measures. If the measures were not met, the employees in that unit are not entitled to receive performance pay.

In 2006 the Department of Administration recommended continuation of the original 5-year plan. The FY 2008 budget included an appropriation that provided for a 3.0% increase to base salaries, and an increase in the funding authorized for performance pay, bringing the total amount of performance pay available up to 2.75%.

In 2007 the State was experiencing the beginning of a budget crisis. The Department of Administration did not recommend a specific amount for salary increases due to the uncertainty of the budget situation in September 2007. The FY 2009 budget did not provide for any salary increases.

Figure 1
History of the State's Compensation Adjustments

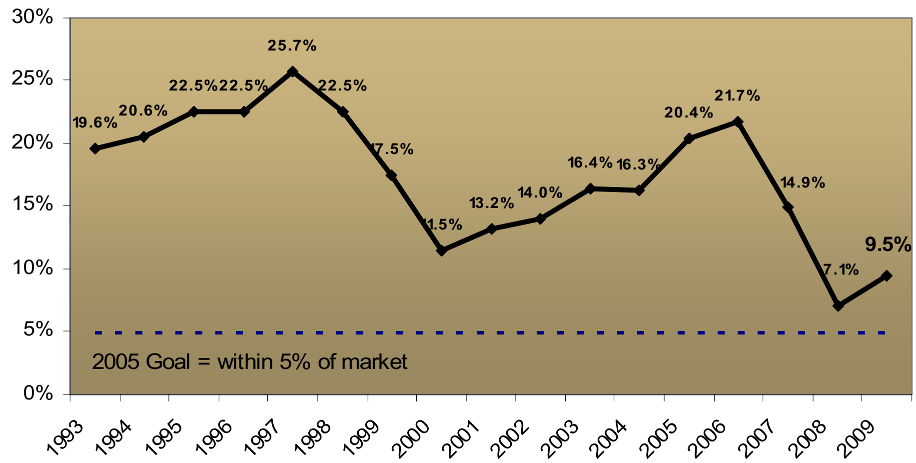
Recommendation Year (Calendar Year)	Budget Year (Fiscal Year)	Average Covered Salary	General Salary Adjustments	Merit or Performance	Allocations for Selected Classes
1996	1998	$26,874	2.5%	2.5% Merit	Yes
1997	1999	$28,249	-0-	2.5% Merit	Yes
1998	2000	$29,208	-0-	2% Merit	Yes
1999	2001	$29,725	-0-	2% Merit	Yes
2000	2002	$30,331	$1,450		
2001	2003	$31,824	-0-		
2002	2004	$31,859	-0-		
2003	2005	$32,059	$1,000		Yes
2004	2006	$32,897	1.7%		Yes
2005	2007	$36,195	$1,650	2.5% Perf Pay	Yes
2006	2008	$38,023	3.0%	0.25% Perf Pay	Yes
2007	2009	$38,097	-0-		

Source: Joint Legislative Budget Committee FY2008 Appropriations Report. Merit Adjustment figures represent the percentage allocated to an agency's personnel services base. Allocations for Selected Classes are provided to address specific job classes or specific agency needs addressed by legislation. Average Covered Salary data are based on regular covered employees in agencies within the ADOA Personnel System calculated as of the end of July; figures for FY 2007, 2008, and 2009 have been adjusted to account for performance pay.

CURRENT STATE OF COMPENSATION

The job market is a constantly moving target, and state salaries must continually be analyzed to assess the competitive position of the state with respect to the market. The most recent analysis of market competitiveness suggests the market exceeds state salaries by an estimated 9.5%. Figure 2 below illustrates the relative difference between state salaries and the market.

Figure 2 – Percent Needed to Get to Market



Source: Percent Needed to Get to Market is based on a suite of compensation surveys, including the Arizona Compensation Survey (previously refered to as the Joint Governmental Salary Survey). Average State Employee Salaries are based on employees in the ADOA Personnel System calculated as of the beginning of the fiscal year (July 1). Estimates for FY 2009 have been adjusted to account for performance pay.

FUTURE CONSIDERATIONS

There are a number of factors that must be considered in developing a strategy to ensure state salaries become competitive.

Market Movement

When reviewing information from compensation consulting firms, employers are asked to predict or project the increases that will occur in the future. Several surveys were analyzed to identify an overall projection (Figure 3). It is estimated that the job market is likely to increase by 3.8% during FY 2009. One survey source included the following, "Salary budgets are projected to continue their steady growth despite a troubled economy."

Figure 3 – Actual and Projected Salary Increases

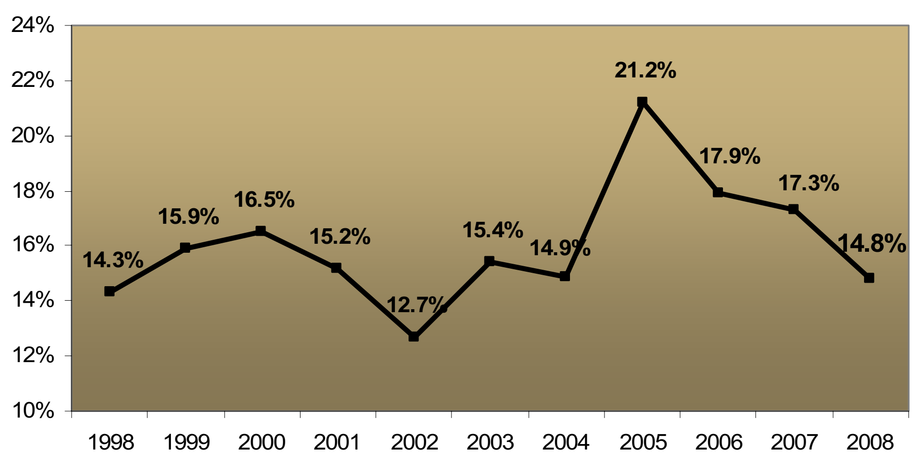
Reference	2008 Actual Increase	2009 Projected Increase
National - Mercer	3.8%	3.7%
National - WorldatWork	3.9%	3.9%
Regional - CompData	3.6%	3.6%
Arizona - ERI	4.1%	4.0%
Arizona – ACS	3.6%	3.7%
Phoenix - WorldatWork	3.8%	3.8%
State of Arizona	**0%**	**TBD**

Source: National data from Mercer, WorldatWork, and CompData websites; Arizona data from Economic Research Institute and 2008 Arizona Compensation Survey; Phoenix data from WorldatWork.

Turnover

The separation rate of covered employees decreased again in 2008 from near historic highs of over 21% in 2005 (Figure 4). This rate represents the third consecutive year of decreasing turnover rates and suggests a return to what had been a reasonably steady average of 15%-16%. This figure makes an interesting supplement to Figure 2 on page 3, which shows the trend of state salaries compared to the market. When state salaries were closest to the market (2000 and 2001), the turnover rates dropped sharply in the following years. After that time, as state employee salaries began to fall significantly behind the market, the state experienced ever increasing turnover rates. As the state's market competitiveness returned in 2007 and 2008, turnover rates again began decreasing in the following years. It remains to be seen if state salaries are able to remain competitive with the market, whether turnover rates will continue to be held at lower levels.

Figure 4 – Separation Rates of Covered Employees



Source: 2008 State of Arizona Workforce Report. Separations are defined as covered employees leaving state service during the fiscal year (July 1 to June 30).

Although turnover rates are decreasing, it is important to note that the state is experiencing higher turnover than other states, and higher turnover than other local public sector employers (Figures 5 and 6)

Figure 5 – Separation Rates of Local Public Employers

Employer	Annual Separation Rate
Phoenix	6.6%
Chandler	8.8%
Tucson	8.9%
Scottsdale	9.0%
Mesa	9.1%
Tempe	9.1%
Yuma	9.2%
Glendale	9.4%
Goodyear	10.0%
Gilbert	11.2%
Peoria	11.2%
Average	**11.3%**
Maricopa County	11.6%
Pima County	11.8%
Yuma County	13.9%
Pinal County	14.7%
State of Arizona	**14.8%**
Flagstaff	16.5%
Wickenburg	21.0%

Source: Individual Contacts, Information presented is the most current available. Average illustrates simple average of local employers excluding the State of Arizona.

Figure 6 – Separation Rates of State Governments - 2007

State	Annual Separation Rate
Oregon	5.9%
Massachussets	8.4%
Washington	9.0%
Utah	11.4%
Missouri	12.7%
Montana	12.8%
Colorado	13.1%
New Mexico	13.2%
Wyoming	13.4%
Arizona	**14.8%**
Idaho	15.9%
National Average	**16.9%**
Texas	17.4%

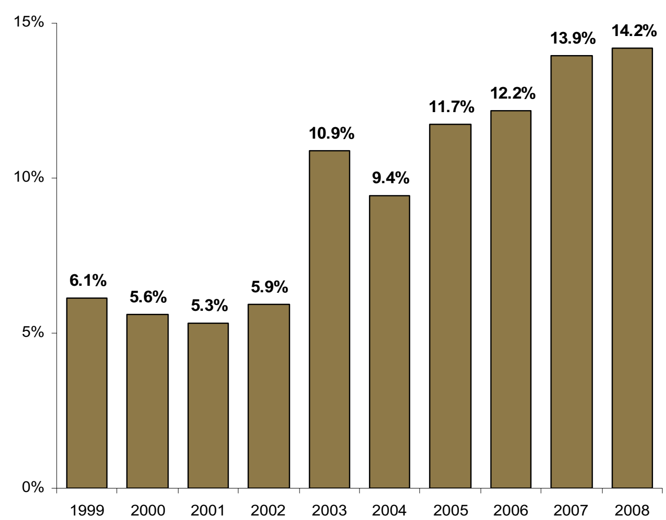
Source: Individual Contacts and web pages; information presented is the most current available. National average from U.S. Dept of Labor, Bureau of Labor Statistics; values represent separations from State and Local governments during FY 2007.

When an employee leaves an organization, the organization usually experiences substantial costs. Costs to the employer may include decreased productivity, costs of hiring a new employee, increased training time, and other indirect costs as well as reduced levels of service to the customer. The estimated total cost of losing a single person to turnover range from 30% of their yearly salary to 150%. The current turnover rate of 14.8% results in an estimated total cost of over $49.2 million (2008 State of Arizona Workforce Report).

Increasing Retirement

One of the most critical issues facing the state is the ability to retain a skilled and effective workforce. This may be especially poignant with the well-documented trend of increasing retirements and the loss of institutional knowledge. Figure 7 shows that the percentage of separations as a result of retirement has significantly increased over the last five years and is currently at the highest level in recent history. The average rate from 1998 through 2002 was 5.8%; the rate in 2007 was over 2.4 times greater.

Figure 7 – Percent of Separations Due to Retirement



Source: 2007 State of Arizona Workforce Report.

The projections for the future suggest this pattern is not likely to change. Half of the larger state agencies are expected to have over 25% of their active workforce eligible to retire in the next five years (2008 ADOA Human Resources System Annual Report).

Economic Forces

Another factor that must be considered when developing a strategy to address employee salaries is the state of the economy. At the national level, a recent Associated Press article indicated that inflation is increasing at the fastest pace in 17 years, the job market is under further strain, and foreclosure filings are surging. Further comments about inflation indicated, "Families have now lost an entire decade's worth of raises to inflation as weekly earnings adjusted for inflation lies below the level they reached in August 1998."

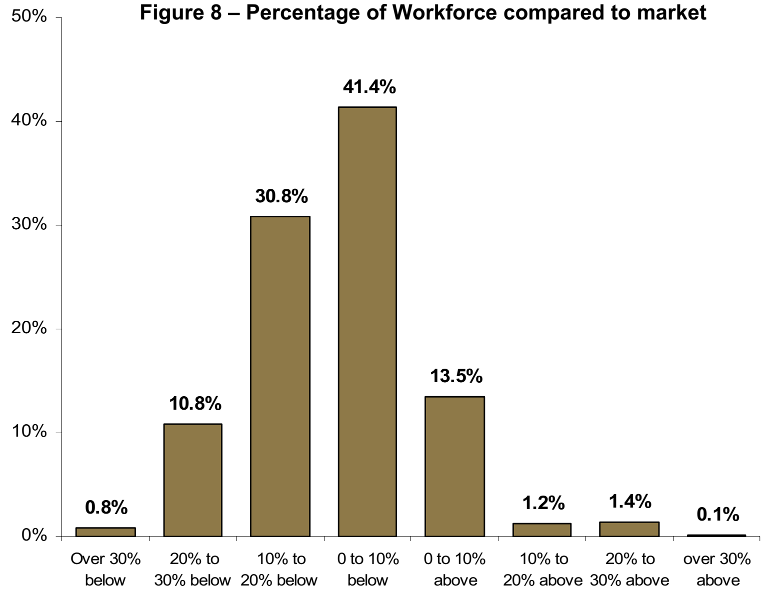
Closer to home, the economic picture in Arizona isn't any brighter. The latest Arizona Blue Chip Economic Forecast shows drops in employment, retail sales, housing, and population growth. The condition of the state's economy was aptly summarized in the July 2008 issue of Arizona's Ecomony (Eller College of Management, University of Arizona)

> *While analysts debate whether malaise in the U.S. economy will last long enough, be deep enough, and widespread enough to qualify as recession, there is little doubt that Arizona's economy already has passed these tests. Homebuilding is in one of the sharpest corrections on record, consumers are in full retreat, and measure after measure of economic activity is at recessionary levels. The questions now are "how long and how bad?"*

Strategic Use of Limited Resources

Given the fiscal challenges that the state is facing, it is more important than ever that the state's limited resources are used in a manner that is effective and efficient. In the past, there are usually selected classifications that receive funding allocations to address specific management issues (see Figure 1). There are many factors that must be considered when targeting salary adjustments at specific classifications, such as turnover rates for the classification, difficulty in recruiting, and internal equity issues. However, the distance from the market is one of the most significant factors that must be addressed. Figure 8 illustrates that over 11% of the state's workforce is currently compensated at a rate that is more than 20% below the market value for their specific classification.

Figure 8 – Percentage of Workforce compared to market



CONCLUSION

The state made significant progress towards improving the position of state employee salaries to the market during FY 2007 and FY 2008. The Executive and Legislative branches sent a clear message to state employees that salary issues were important. During the development of the FY 2007 budget, state employee salaries were addressed early in the budgeting process and employees were provided an increase of $1,650, and a new program for performance pay was introduced which afforded eligible employees an additional 2.5%. The development of the FY 2008 budget also demonstrated a significant commitment to address salary issues with an appropriation of 3.0% and an increase of 0.25% to the performance pay program, raising the total available through performance pay to 2.75%.

Nevertheless, the market continues to move forward. When the state did not allocate funding for salary increases in FY2009, there was an overall loss in the ground that had been made in closing the gap between the market and state salaries. The market is estimated to exceed state salaries by 9.5%, and projected increases in the market of 3% to 4% highlight the critical importance of continuing to make progress at bringing salaries closer to market levels.

RECOMMENDATION

The Advisory Recommendation on State Employee Salaries, published in September 2005, outlined a multi-year strategy with a goal to bring employee salaries within 95% of market in five years.

This year's recommendation includes the following components:

- Continuation of the multi-year strategy and the goal to be within 95% of market by FY 2011
    - The first two years of the plan (Fiscal Years 2007 and 2008) resulted in bringing salaries closer to market, however, some of that progress was lost in FY 2009. By remaining committed to this plan, it is expected that the state will achieve the goal of being within 5% of the market.
- In order to continue the State's progress toward the goal of being within 95% of the market, salary increases should be implemented.
- Continuation of Performance Pay