Arizona
HUMAN RESOURCES

State of Arizona Advisory Recommendation

Janice K. Brewer
Governor

2012

Brian C. McNeil, Director
Department of Administration

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ARIZONA DEPARTMENT OF ADMINISTRATION

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December 26, 2012

The Honorable Janice K. Brewer
Governor, State of Arizona
The Honorable Steve Pierce
President, Arizona State Senate
The Honorable Andy Biggs
President-elect, Arizona State Senate
The Honorable Andy Tobin
Speaker, Arizona House of Representatives
1700 West Washington
Phoenix, Arizona 85007

Dear Governor Brewer, President Pierce, President-elect Biggs, and Speaker Tobin:

Pursuant to Arizona Revised Statutes section 41-751, the 2012 Advisory Recommendation is intended to provide information concerning the compensation of state employees and an objective assessment of the job market.

On September 29, 2012, personnel reform became effective and a new personnel system was implemented. Significant time and effort was invested in these changes that will enable the state to attract and retain top performing employees and instill a culture of high performance. Supporting this year's recommendation and providing meaningful salary increases demonstrates commitment and support of the systemic changes that were implemented with personnel reform.

State employee salaries are now estimated to be 17.1% behind the job market. Last year the urgent need to address salaries was recognized, and with your support, a one-time 5% critical retention payment for employees that were at-will uncovered as of September 29, 2012 was authorized. The 5% payment will be distributed evenly over 19 pay periods in FY2013. A significant component of this year's recommendation is the continuation of the 5% retention payments.

The other component of this recommendation is the funding to support merit increases for top performing employees. The last time funding was authorized for merit increases was in FY2001. Providing funding for merit increases would send a powerful message to the workforce that performance does matter and meaningful investment in compensation supports the overall intent of personnel reform.

This Advisory Recommendation provides important information needed when making decisions regarding Arizona state government and its employees' compensation.

Sincerely,

Brian C. McNeil
Director

2012 Advisory Recommendation on State Employees' Salaries

Introduction

Every year, the Arizona Department of Administration (ADOA) provides an Advisory Recommendation to the Governor and the Legislature pursuant to A.R.S. §41-751. 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. These factors include turnover rates, retirement projections, economic forecasts, and projected market movement. The report concludes with a recommendation to the salary plan for state employees.

> *This report reflects the current status of Arizona state employee compensation as it relates to market conditions at the end of Fiscal Year 2012. The guidelines contained herein are provided as a resource to guide statewide budget considerations during the preparation of the Fiscal Year 2014 budget.*

Current Environment – State Government

History of Salary Adjustments

Figure 1
History of the State's Compensation Adjustments[1]

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	-0-	
2001	2003	$31,824	-0-	-0-	
2002	2004	$31,859	-0-	-0-	
2003	2005	$32,059	$1,000	-0-	Yes
2004	2006	$32,897	1.7%	-0-	Yes
2005	2007	$36,195	$1,650	2.5% Perf Pay	Yes
2006	2008	$38,023	3.0%	Additional 0.25% Perf Pay	Yes
2007	2009	$38,097	-0-	-0-	
2008	2010	$38,478	-0-	-0-	
2009	2011	$37,684	-0-	**2.75% Perf Pay Eliminated**	
2010	2012	$37,535	-0-	-0-	
2011	2013	$37,397	-0-	-0-	One-Time 5% Uncovered Retention Pay*

[1] Source: Joint Legislative Budget Committee FY 2012 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, 2009, and 2010 have been adjusted to account for performance pay. Average salary for FY 2011 and FY 2012 does not include performance pay.
* 5% Retention Payments are not added to base salary and authorized for 19 pay periods in FY2013.

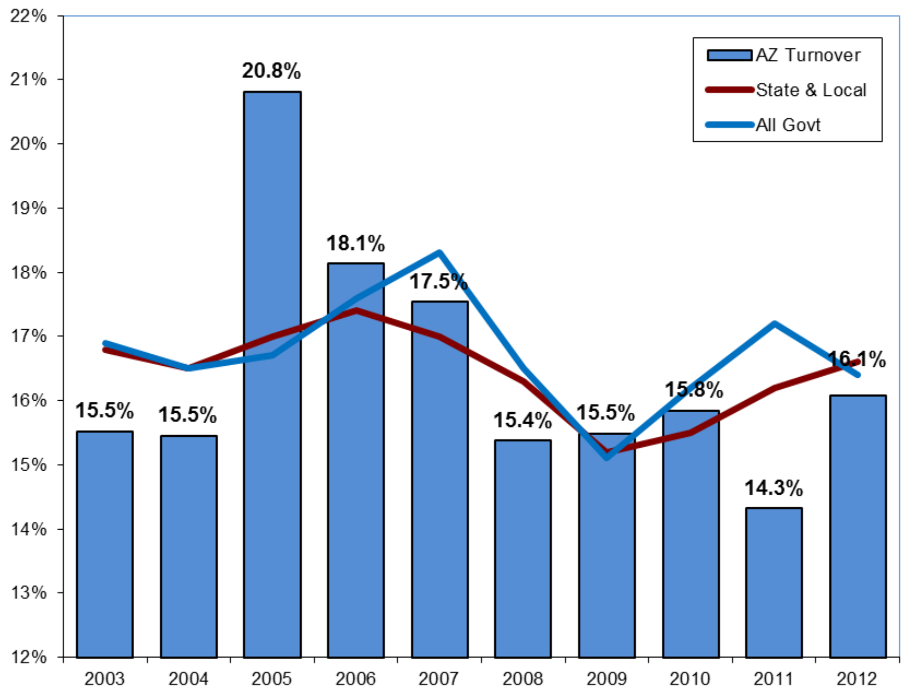
Average Salary

The statewide average annual salary for covered employees was $37,397 in FY2012, dropping to the lowest level since FY2008[2]. In FY2012, covered employees represented 81% of the workforce after excluding limited, seasonal, and part-time employees working less than 0.25 full-time equivalents.

Turnover Rates

The separation rate for both covered and at-will uncovered employees increased in FY2012 from 14.3% to 16.1%, however, a portion of this increase was due to the legislatively mandated outsourcing of the Department of Corrections Health Care unit. If this outsourcing were removed from the calculations, the total separation rate for both covered and at-will uncovered employees would have been 14.9%[3]. Even considering the outsourcing, the turnover rate for Arizona was still less than other public sector benchmarks[4].

Figure 2
Separation Rates – Arizona Compared to Benchmarks – FY2003 to 2012



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[2] Table 1-1 – Agency Comparison of Average Salary per Covered Employee. Fiscal Year 2008 – 2012. State of Arizona Workforce Report. 2012.

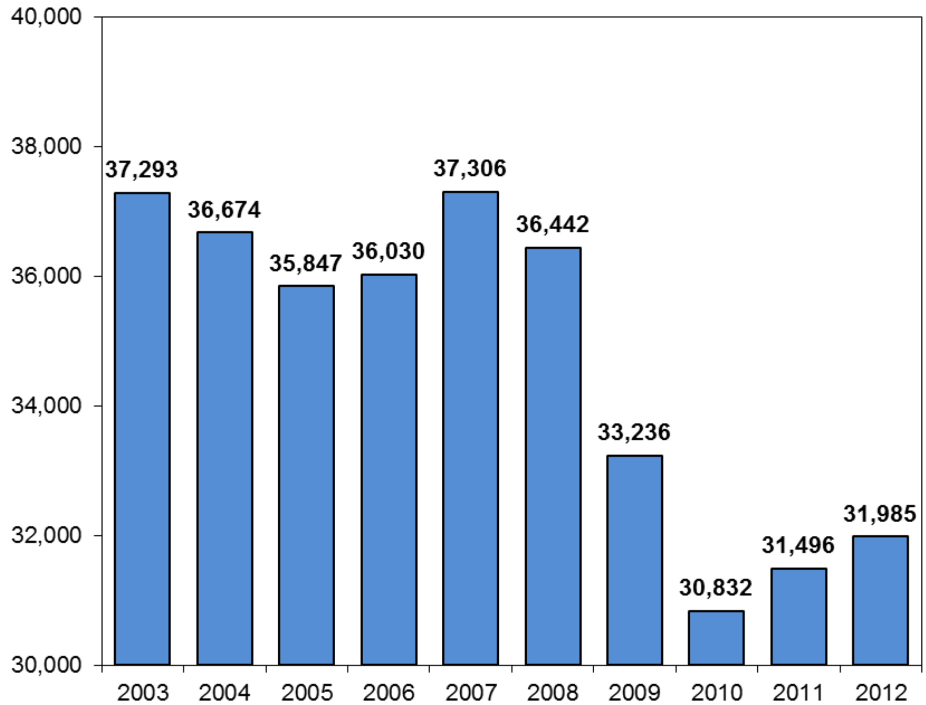
[3] Table 2-1 – Ten Years of Changes in Separations by Covered and Uncovered Employees. Fiscal Year 2003 – 2012. State of Arizona Workforce Report. 2012.

[4] Table 2-4 – Separation Rates – Arizona Compared to Benchmarks. Fiscal Year 2003 – 2012. State of Arizona Workforce Report. 2012.

Reduction in Total Size of Government

The total size of state government was dramatically reduced during the years from 2007 to 2010, as the state managed one of the worst financial and economic crises in the nation. During those years, reductions in force and layoffs occurred in most agencies, and a hiring freeze was implemented that ensured further reductions through attrition. Although there have been slight increases in the size of the workforce in the last two years, total staffing levels still remain far below previous levels. In FY2012 the total size of the workforce was 31,985 which represents a 12.2% reduction from the size of the workforce in FY2008.

Figure 3
Employee Headcount – Arizona Department of Administration Personnel System[5]

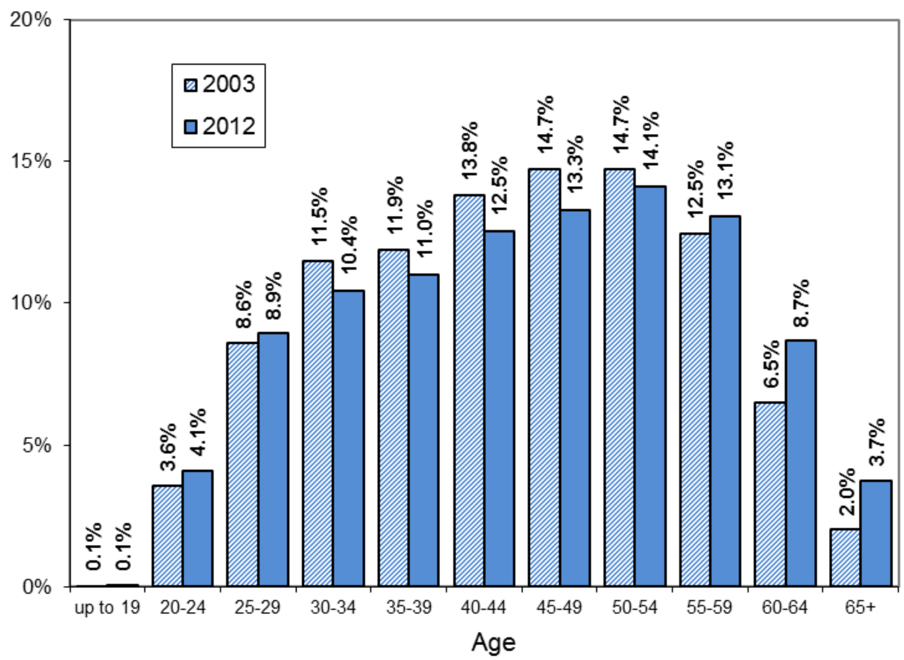


[5] Figure B – Employee Headcount – ADOA Personnel System. Fiscal Year 2003 – 2012. State of Arizona Workforce Report. 2012.

Average Age of the Workforce

In FY2012 the average age of a state employee was 45.5 years of age, compared to the average of 44.1 years in FY2003. Of significant note, there are more employees in the three oldest age groups now than there were ten years ago, illustrating a trend toward advancing age of the workforce. In 2003, only 21% of the workforce was over the age of 55. Currently those over the age of 55 account for 25.5% of the workforce.

Figure 4
Age Distribution – FY2003 and FY2012[6]

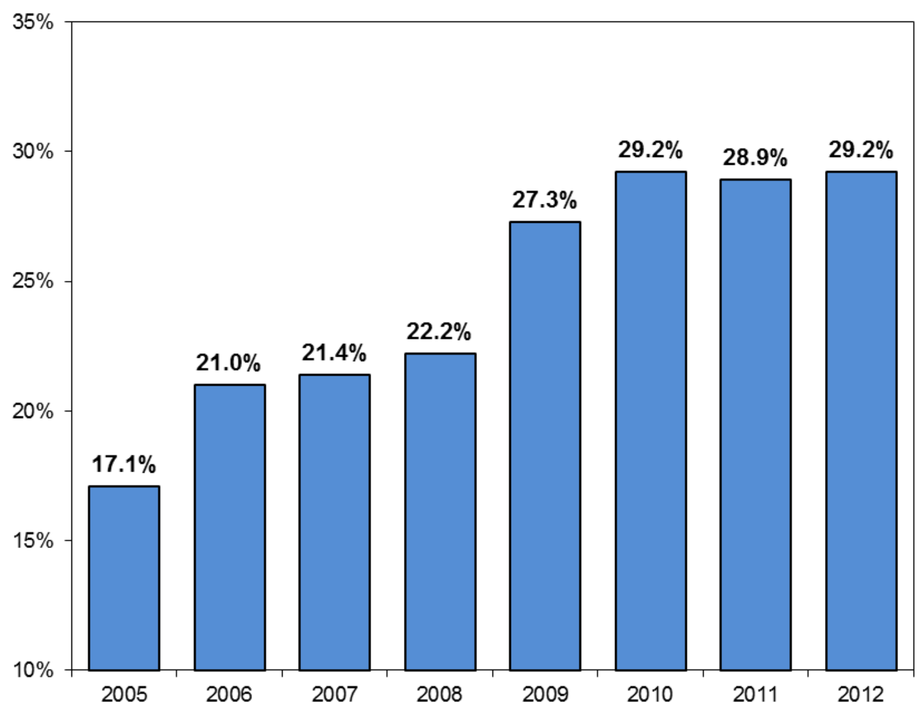


[6] Table 4-8 – Age Distribution for All Employees. Fiscal Year 2003 and 2012. State of Arizona Workforce Report. 2012.

Retirement Rates & Projections

Nearly 90% of the larger state agencies are projected to have at least 25% of their workforce eligible to retire within the next five years. Overall, considering the entire workforce, nearly 30% of the workforce is estimated to be eligible for retirement within the next five years. In some agencies these numbers are much higher; there are six agencies in the state that are now estimated to have over 40% of their active workforce eligible to retire in five years. The chart below illustrates the increasing trend of expected separations of seasoned, tenured employees due to retirement.

Figure 5
Projection of Retirement Eligibility[7]



The combination of the advancing age of the workforce and the high percentage of the workforce that is, or will soon be eligible for retirement significantly and dramatically highlights the need for the state to be competitive in the labor market to attract future top talent.

[7] Retirement Eligibility. Various State of Arizona Workforce Reports, 2005 through 2012. Projections of retirement eligibility are based on a five-year horizon considering employees' years of service and age criteria for the Arizona State Retirement System and the Public Safety Personnel Retirement System. Many state employees continue to remain employed even after they become eligible to retire.

Current Environment – Competitive Job Market

Distance Off Market

The job market is constantly moving, 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 employee base salaries by an estimated 17.1%.

Figure 5
Percent Needed to Get to Market[8]

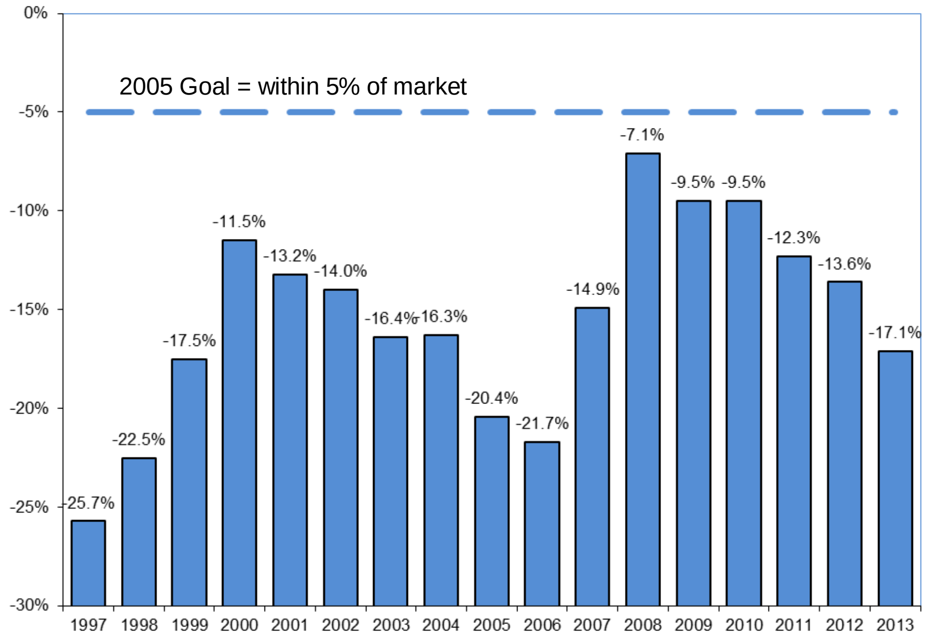


Figure 6
Actual and Projected Base Salary Increases[9]

Reference	2011 Actual	2012 Actual	2013 Projected
National - Hay	3.0%	2.8%	3.0%
National - WorldatWork	2.8%	2.8%	3.0%
Local (Phoenix) - WorldatWork	2.8%	2.7%	2.9%
Local (Public & Private) AZ Compensation Survey	1.9%	2.3%	2.5%
Local (Public Sector Only) AZ Compensation Survey	0.6%	0.9%	1.1%
State of Arizona	**0%**	**0%**	**0%**

Recognizing the urgent need to address salaries, the Governor and the Legislature authorized a one-time 5% critical retention payment to employees that were at-will uncovered as of September 29, 2012. The 5% payment will be distributed evenly for 19 pay periods throughout FY2013.

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[8] Percent Needed to Get to Market is based on a suite of compensation surveys, including the Arizona Compensation Survey (previously referred 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).

[9] National data from Hay and WorldatWork websites; Arizona data from 2012 Arizona Compensation Survey.

Changes to State Government Workforce

Personnel Reform

One of the most sweeping changes to Arizona's governmental infrastructure was implemented in the latter part of FY2012. In January 2011, Governor Brewer issued a policy agenda that was based on four cornerstones of reform. One of those cornerstones was the need to reform how state government operates, and a critical piece of that involved operational reforms. Although personnel reform was not implemented during that Legislative session, much of the groundwork and research was completed, such that during the next Legislative session, a comprehensive and thorough bill could be introduced. In May 2012, Governor Brewer signed sweeping personnel reform into law, modernizing the way in which state government manages, hires, and fires employees. With this change, the existing cumbersome personnel system, which had the effect of discouraging the best employees and protecting the weakest performers, was replaced.

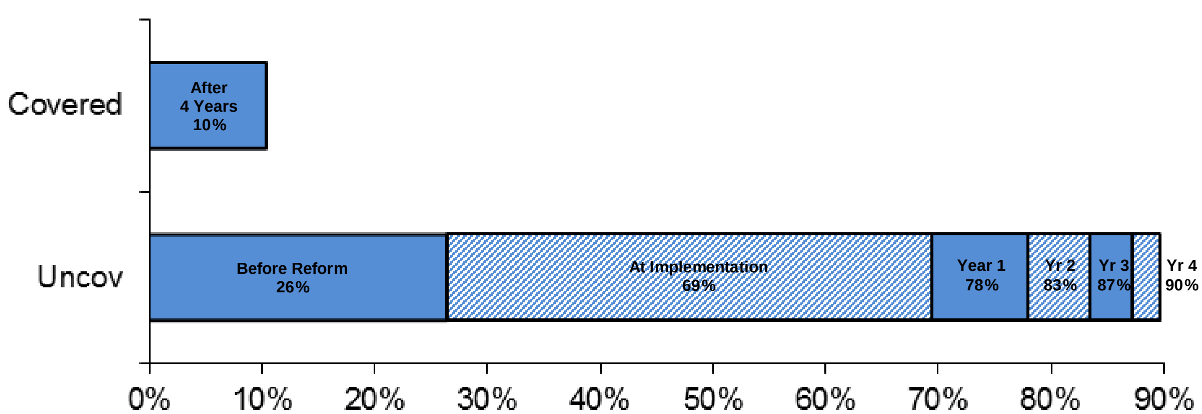
Consolidation of Personnel Systems

At the heart of the personnel reform legislation was the development of a new personnel system. Through the consolidation of several different personnel systems, consistency of human resources practices and the elimination of unnecessary redundancies significant efficiencies will be realized. Furthermore, the incorporation of six guiding principles in statute ensures effective management of the workforce.

Transition to At-Will

At the time of implementation of personnel reform, a number of employees were transitioned from a covered status to an at-will uncovered status. This change included all new hires, all supervisors, all employees in a grade 19 or higher position, all employees in the attorney salary schedule, all employees in the information technology salary schedule, all employees that voluntarily accept a change in assignment, and all employees that otherwise volunteer to transition to at-will uncovered. Immediately prior to implementation, there was a two-week "open enrollment" period when covered employees that were not otherwise required to become at-will uncovered, had an opportunity to volunteer. Nearly 40% of the employees that were eligible, volunteered to become at-will uncovered. As a result, it is now estimated that by 2016, 90% of the workforce (excluding Correctional Officers and Community Correctional Officers) will have transitioned to an at-will uncovered status.

Figure 7
Estimated Transition of the Workforce to At-Will Status



Collectively, implementing a new personnel system, changes to the personnel rules and policies, and transitioning the workforce to an at-will uncovered status, will result in increased productivity, eliminating bureaucratic red tape, and ultimately saving our taxpayers money. The system is based on a model that has been standard practice in the private sector. Perhaps the most meaningful and significant aspect of the system changes is the shift in the culture of the workforce toward a pay for performance mentality.

Performance Management

An integral part of the reform initiative is the system by which the state will identify the top performing employees. The current performance management system is widely known to be ineffective, inefficient, and burdensome, in addition to not being consistently used. Moving forward, a new performance management system will be implemented, ensuring that all eligible employees are evaluated on a consistent framework of competencies, some of which will be uniform across the entire state, and others will be specifically defined by each agency. The performance management system will be implemented with an effective date of January 1, 2013.

This foundational system is necessary to ensure integration with other management decision-making systems. In the future, reports will be generated to assess whether there is a difference in turnover rates between high performers and low performers, whether job advancements and promotions are more prevalent for high performers, and whether salary increases are in fact closely related to job performance.

Compensation System

Many of the compensation strategies that will be available to agency management moving forward will be directly tied to encouraging a performance based approach to compensation. For example, promotional increases will only be available for employees that have received a “meets expectations” rating or better on their most recent performance review. Other salary options will only be available to employees that meet or exceed expectations, and that have not received an involuntary demotion or suspension.

One of the stated goals of personnel reform has been to attract top performers to the state, and to retain the top performers that are currently in the workforce. Given that the size of the overall workforce has been significantly reduced (Figure 3), future success depends on having a highly engaged, high performing team of employees. Compensating them appropriately must be a high priority for the state to remain competitive in the job market as the economy recovers and the war for top talent intensifies.

Classification System

The current classification system has been in place for several decades, in spite of several past attempts to overhaul and revise the classification system. Over the course of the years, the existing classification system has gradually and slowly been changed as a means of addressing compensation issues. Practices such as establishing “special recruitment rates”, developing special salary schedules, and delineating classifications into narrow bands as an artificial means of providing additional “promotional” opportunities, all have served to increase the bureaucracy and burdensome task of managing the classification system.

Moving forward, the classification system will be improved through establishing classifications based on reliable, industry-accepted occupational information and job families and consolidating duplicate or overly restrictive classifications.

Collectively, these strategies of implementing a consistent foundation of performance management and integrating that information with compensation and classification is expected to transform the State Personnel System to be competitive with the prevailing labor market.

Conclusion

As evident in Figure 5, the state made significant progress towards improving the position of state employees' salaries relative to the market during FY 2007 and FY 2008. During those years, the Executive and Legislative branches sent a clear message to state employees that salary issues were important, and the gap between state employees' salaries and the market was reduced to the lowest level in nearly two decades.

Unfortunately, due to the economic challenges at the national and local levels, the state has not allocated funding for salary increases since FY 2008, and in fact moved in the opposite direction in FY 2011 with the elimination of 2.75% performance pay. As a result, the market position of state employees' salaries has declined to the lowest levels since FY2007. Figure 6 illustrates that the market is expected to increase by 2.5-3.0% in FY2013. If no action is taken to address salary issue, state employees will fall even further behind the market.

Recognizing the need to address employee salaries, the Governor advocated a program of 5% critical retention payments for employees that were at-will uncovered as of September 29, 2012, extending through the remainder of the fiscal year. These payments provided temporary relief from the widening disparity between employees' salaries compared with the market. However, it must also be realized that as the economy at the local and national levels improve, the prevailing labor market is also providing salary increases. The net effect is inescapable; continued actions are necessary to ensure the state remains competitive in the labor market.

Recommendation

This year's Advisory Recommendation on state employees' salaries is critically important to support and reinforce the implementation of personnel reform. Changing the culture of state government to embrace a performance based approach to compensation will take some time, but it will also take a financial commitment. The recommendation includes a two-part strategy:

1. Continue Critical Retention Payments

   The 5% critical retention payments that were implemented as of September 29, 2012 were only authorized and funded for the remainder of FY2013 (19 pay periods). To address the tangible difference in employees' salaries compared to the job market, it is recommended to provide a permanent change to the base salary of employees receiving retention payments in the amount of 5%. In other words, convert the retention payments to base salary adjustments. If this base salary adjustment is not implemented, at a minimum, it is recommended that the critical retention payments are continued.

2. Agency Funding for Merit Increases

Most private sector organizations use merit increases as their primary annual salary adjustment process. In the past several years, as a result of very tight fiscal constraints, it is becoming more common for organizations to eliminate merit increases for average performers so they can provide more funding to reward their top performers; especially those who are paid in the lower portion of their salary range[10]. In support of the desired goals of supporting a performance based culture, we recommend each agency be appropriated and funded sufficiently to provide merit increases for their top performing at-will uncovered employees (and Correctional Officers I-III and Community Correctional Officers). The performance management system will be implemented as of January 1, 2013. Most agencies will have completed their employees' annual performance reviews by December 31, 2013, and will be able to award merit increases effective January 1, 2014. Therefore, we recommend sufficient funding to award merit increases during the second half of FY2014.

The Department of Administration will coordinate with both budget offices to develop mutually agreeable guidelines to ensure agencies distribute the bulk of these funds to their highest performers.

Total Estimated Funding: **$16,000,000**

General Fund (39.9%)	**$6,384,594**
Appropriated Fund (27.3%)	**$4,372,617**
Non-Appropriated Fund (12.3%)	**$1,973,451**
Federal Fund (20.4%)	**$3,269,338**

Notes: In accordance with A.R.S. § 41-751, this recommendation only addresses active employees in the State Personnel System. This recommendation does not include appropriate budgeting for vacant positions. The following agencies are excluded from this recommendation: Arizona State University, Auditor General, Board of Regents, Cotton Research Council, Court of Appeals, Department of Public Safety, House of Representatives, Joint Legislative Budget Committee, Law Enforcement Merit System, Legislative Council, Northern Arizona University, School for the Deaf and Blind, Senate, Supreme Court, and University of Arizona. Funding estimate based on HRIS base salary, payroll records for the payperiod ending November 9, an estimated variable ERE rate of 21%, statewide fund allocations from FY2012, and projected funding for six months of FY2014).

[10] Mercer US Inc. State of Arizona: Salary Administration Guidelines/Policy Review. August 13, 2012.