Arizona
HUMAN RESOURCES

State of Arizona
Advisory Recommendation

Janice K. Brewer
Governor

2009

David Raber, Interim Director
Department of Administration

JANICE K. BREWER
Governor

DAVID RABER
Interim Director

ARIZONA DEPARTMENT OF ADMINISTRATION

OFFICE OF THE DIRECTOR
100 North Fifteenth Avenue, Suite 401
Phoenix, Arizona 85007
(602) 542-1500

September 2009

The Honorable Janice K. Brewer
Governor, State of Arizona
The Honorable Robert Burns
President, Arizona State Senate
The Honorable Kirk Adams
Speaker, Arizona House of Representatives
1700 West Washington
Phoenix, Arizona 85007

Dear Governor Brewer, President Burns and Speaker Adams:

Pursuant to Arizona Revised Statutes section 41-763.01, the 2009 Advisory Recommendation is intended to provide information concerning the compensation of state employees and an objective assessment of the job market.

Salary increases provided in 2006 and 2007 significantly reduced the gap between our state employee salaries and the market. The state had previously been almost 22% behind the market; a discrepancy that was significantly affecting agencies' ability to attract and retain quality talent. After the increase in 2007, that gap had been closed to almost 7%, and the state was close to achieving the previously established goal to be within 5% of the market.

Unfortunately, the economy at both the national and local levels suffered severe setbacks. In 2008 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 salary increases in 2008 and 2009. Subsequently the state lost ground to the prevailing job market and salaries are currently estimated to be 9.5% behind the market.

Given the realities of the state's current budget situation and considering the health of the economy and the estimated movement of employee salaries in the market, the Department is recommending to defer any salary increases until budget conditions improve. As soon as it is fiscally possible, addressing issues of state employee compensation should be a priority and the goal of bringing salaries within 5% of the market should be addressed.

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,

David Raber
Interim Director

2009 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, economic forecasts, 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 2009. The guidelines contained herein are provided as a resource to guide statewide budget considerations during the preparation of the Fiscal Year 2011 budget.*

METHODOLOGY

The improvements to the report methodology introduced in 2007 have been retained and enhanced in this current report. We increased the number of 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.

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.

In 2008 the state was deep in the throes of the worst budget crisis in recent history. The Department of Administration again did not recommend a specific amount for salary increases due to the uncertainty of the budget situation in September 2008. The FY 2010 budget did not provide for any salary increases.

Figure 1
History of the State's Compensation Adjustments

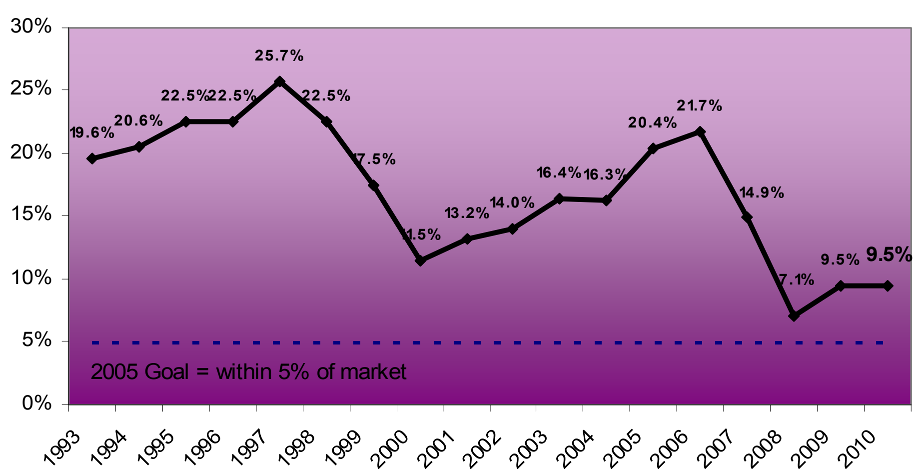
Recommendation Year (Calendar Year)	Budget Year (Fiscal Year)	Average Covered Salary	General Salary Adjustments	Merit or Performance	Allocations for Selected Classes
1996	1998	$26,874	2.5%	2.5% Merit	Yes
1997	1999	$28,249	-0-	2.5% Merit	Yes
1998	2000	$29,208	-0-	2% Merit	Yes
1999	2001	$29,725	-0-	2% 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-		
2008	2010	$38,478	-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, 2009, and 2010 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, including predictions of future market movement.

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 estimate market movement in the coming year (Figure 3). It is worth noting that in 2007 and 2008, salary increases were typically in the range of 3-4%. Salary increases in 2009 were closer to 2%, with one report included the following comment; “Pay raises are the smallest in decades, surveys show.” While organizations nationally and regionally estimate increases averaging 2.5% in 2010, of particular importance to this report, the estimated increase for public sector organizations in 2010 in Arizona is 0.5%. Note that these are averages, and some organizations are projecting decreases or no salary increases for 2010.

Figure 3 – Actual and Projected Salary Increases

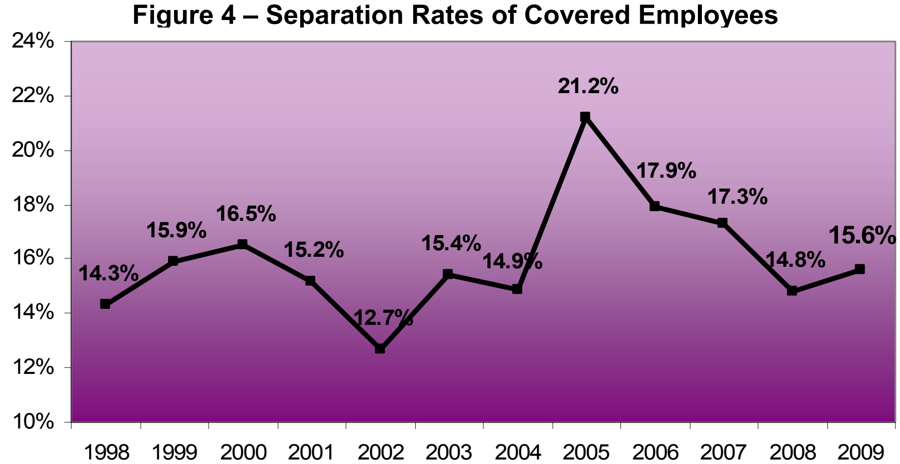
Reference	2007 Actual Increase	2008 Actual Increase	2009 Actual Increase	2010 Projected Increase
National - Mercer	3.9%	3.8%	2.3%	2.7%
National - WorldatWork	3.9%	3.9%	2.2%	2.8%
Regional - CompData	N/A	3.6%	2.5%	2.7%
Arizona – Public & Private	3.9%	3.6%	1.9%	1.9%
Arizona – Public Sector Only			1.1%	0.5%
Phoenix - WorldatWork	N/A	3.8%	1.8%	2.8%
State of Arizona	**3.25%**	**0%**	**0%**	**TBD**

Source: National data from Mercer, WorldatWork, and CompData websites; Arizona data from Economic Research Institute and 2009 Arizona Compensation Survey; Phoenix data from WorldatWork.

Turnover

The separation rate of covered employees increased slightly in 2009 (Figure 4). This change suggests a return to the ten year average of 16.2%. 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 current levels.

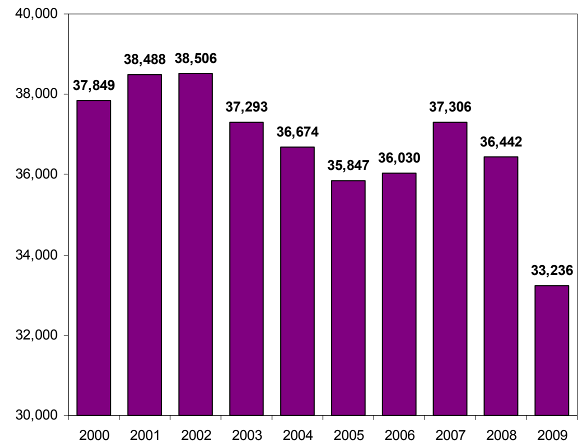
Figure 4 – Separation Rates of Covered Employees



Source: 2009 State of Arizona Workforce Report. Separations are defined as covered employees leaving state service during the fiscal year (July 1 to June 30).

Of particular interest in 2009 was the dramatic and significant reduction in the size of the government's workforce. The number of filled positions in the ADOA Personnel System decreased by 8.8%, to the lowest levels in the past decade (Figure 5). As a result of budgetary constraints, in addition to implementing a statewide hiring freeze, many agencies were required to implement layoffs and reductions in force. Thus, although total turnover may have slightly increased in 2009, the rate of voluntary resignations experienced a 25% reduction, while the rate of involuntary terminations increased by nearly 200% from the year before.

Figure 5 – Employee Headcount – ADOA Personnel System



Source: 2009 State of Arizona Workforce Report.

Although turnover rates appear to be returning to historic averages, it is important to note that in general, the state is experiencing higher turnover than most other states, and higher turnover than other local public sector employers (Figures 6 and 7).

Figure 6 – Separation Rates of Local Public Employers - 2009

Employer	Annual Separation Rate
Phoenix	6.0%
Tempe	7.4%
Gilbert	9.4%
Maricopa County	9.6%
Pinal County	12.0%
Mesa	13.6%
Yuma County	15.0%
State of Arizona	**15.6%**

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

Figure 7 – Separation Rates of State Governments - 2009

State	Annual Separation Rate
Minnesota	5.6%
Wisconsin	7.0%
Oregon	7.3%
Colorado	8.5%
South Dakota	10.5%
Nevada	10.6%
Missouri	10.7%
Wyoming	12.9%
Indiana	13.3%
Nebraska	15.6%
Arizona	**15.6%**
Texas	17.3%

Source: Individual Contacts and web pages; information presented is the most current available.

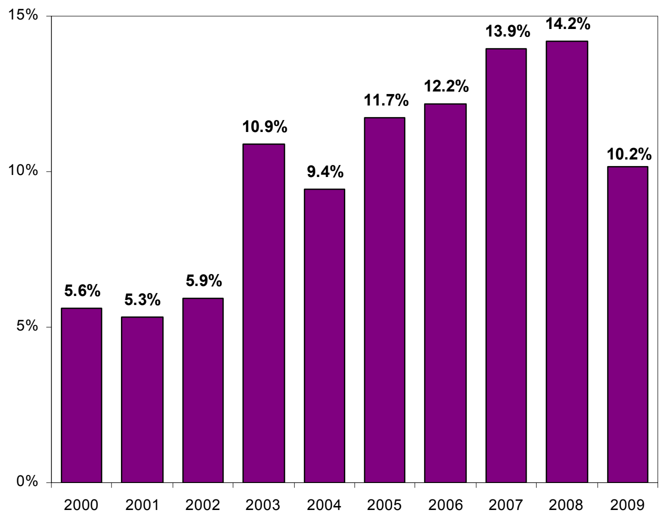
When an employee leaves an organization, the employer usually experiences substantial costs. Costs to the employer may include decreased productivity, costs of hiring a new employee, increased training time, and other indirect costs as well as reduced levels of service to the customer. The estimated total cost of losing a single person to turnover ranges from 30% of their yearly salary to 150%. The current turnover rate of 15.6% results in an estimated total cost of nearly $48 million per year (2009 State of Arizona Workforce Report).

Retirement Rates

One of the 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 8).

What economists failed to predict, however, was the dramatic impact of the national and local economy and how that affects employees' retirement decisions. The loss of value in retirement savings, combined with the increasing costs of health care and other factors, may significantly alter retirement rates for several years, as employees choose to continue working.

Figure 8 – Percent of Separations Due to Retirement



Source: 2009 State of Arizona Workforce Report.

Although nearly 75% of the larger state agencies are expected to have over 25% of their active workforce eligible to retire in the next five years (2009 ADOA Human Resources System Annual Report), it remains to be seen whether employees will actually choose to retire when they become eligible. The significant decrease in the percent of separations due to retirement in 2009 may indicate the beginning of a trend returning to lower rates of retirement.

Economic Forces

A key factor that must be taken into consideration when developing a compensation strategy to address employee salaries is the health of the economy. At the national level in June 2009, there were emerging signs that the economy was stabilizing. One advisor reported, "Business economists look for the recession to end soon, but the economic recovery is likely to be considerably more moderate than those typically experienced following steep declines." The unemployment rate is forecast to rise to 9.8% by year-end and inflation is expected to moderate[1].

If news at the national level was less than encouraging, economic forecasts for Arizona are even more sobering. The Arizona Department of Commerce reported that Arizona's unemployment rate jumped half a percentage point, to 9.2% in July 2009, with economists projecting the jobless number to exceed 10% before conditions improve. And it is widely thought that Arizona's true jobless rate could be 5 to 7 percentage points higher. The Economic & Business Research Center at the University of Arizona recently reported,

> *'We continue to expect the recession nationwide to come to an end during the summer followed by a gradual recovery. Arizona is expected to lag behind by at least a quarter or two due to lingering challenges facing real estate and massive layoffs in the public sector that still lay ahead."*

[1] National Association for Business Economics, June 2009

CONCLUSION

The state made significant progress towards improving the position of state employee salaries relative 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, and the gap between state employee 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 did not allocate funding for salary increases in FY 2009, and the market position of state employee salaries declined. As the economic conditions worsened through the past year, all industries were affected, and although the state again did not allocate funding for salary increases in FY 2010, fortunately state salaries did not lose further ground compared with the market.

It is expected however, that when economic conditions begin to improve, the public sector will lag the private sector, and further erosion of state employee salaries may become evident.

RECOMMENDATION

The Department of Administration understands and appreciates the realities of the the current economic situation of the state's budget. When taken into consideration along with the health of the economy, both at a national and state level, and considering the estimated movement of employee salaries in the market, the Department is recommending to defer any salary increases until budget conditions improve. As soon as it is fiscally possible, addressing issues of state employee compensation should be a priority and the goal of bringing salaries within 5% of the market should be addressed.