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## **A Biennial Report on Recommended Adjustments to the Classification Salary Schedules**

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# Key Points of Report

## A Biennial Report on Recommended Adjustments to the Classification Salary Schedules

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### Overall Conclusion

We recommend that the Legislature increase the Classification Salary Schedules (Schedules) by a minimum of 3.9 percent for each year of the 2000-2001 biennium. This would cost approximately \$472 million for the biennium (\$155 million in fiscal year 2000 and \$317 million in fiscal year 2001). These recommended increases would only maintain the State's position in the market as of 1998. A booming economy, tight job market, and low unemployment have all led to a shortage of skilled state employees. The State cannot keep the Schedules at their current levels if it wants to successfully attract and retain these workers.

### Key Facts and Findings

- On average, state employees have cumulatively lost \$5,438 in real earnings over the last five years. This loss is due to inflation. This is even more a cause for concern since many private sector employees have actually gained real earnings in recent years since their salary increases exceeded inflation.
- The State's classified salary schedules have not kept pace with national and regional salary structure increases in recent years. State employees' salaries have actually fallen 14.2 percent behind the Central Texas market since 1994. The State will continue to lose ground compared to the market if the Schedules are not increased in fiscal years 2000 and 2001.
- The value of state employees' benefits is declining. Benefits for new state employees who are ineligible for benefit replacement pay lag the national average. The State's total compensation package, including base salaries and benefits, is vital to maintain a competitive position. As benefits decrease, the importance of competitive salaries increases.
- The State's turnover rate has steadily increased over the past three years. In 1997, the State spent between \$93 and \$186 million on turnover-related costs. Turnover is costly for the State as it reduces efficiency, interrupts operations, and lowers employee moral.
- A percentage increase, rather than a flat-dollar increase, is necessary to address professional and managerial employee salaries which lag the market more than those of other state positions.

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### Office of the State Auditor

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*The Classification Office conducted the salary studies and developed the findings and recommendations in this report in accordance with the Position Classification Act, Texas Government Code, Chapter 654.*

# Overview

We recommend that the Legislature increase Classification Salary Schedules A, B, and C by a minimum of 3.9 percent for each year of the 2000-2001 biennium. The salary structure adjustments would cost approximately \$472 million for the biennium (\$155 million in fiscal year 2000 and \$317 million in fiscal year 2001). We believe these percentage increases are vital because:

- The State is at risk of not being able to attract and retain qualified employees.
  - On average, state employees have cumulatively lost \$5,438 in real earnings (purchasing power) since 1993.
  - The Classification Salary Schedules have not kept pace with national and regional salary structure increases for four of the last five years. State employee salaries have fallen at least 14.2 percent behind the Central Texas market since 1994.
  - Benefits (as a percentage of payroll) for state employees are declining and benefits provided to new state employees lag the national average.
  - Texas government's turnover rates are higher than national and other states' rates. Costs associated with turnover are high.

- A strong state and local economy increases competition for employees.
- A percentage increase improves the competitiveness of professional and managerial salaries more than a flat-dollar increase.

As part of a sound compensation program, the State's Classification Salary Schedules should be adjusted periodically to ensure that classified salaries remain competitive with relevant labor markets. Non-competitive salaries weaken the State's ability to attract and retain the number of quality people necessary to conduct the State's business.

The multiple salary schedule system was established last biennium to give agencies greater flexibility in recruiting and retaining professional and managerial employees. However, the adoption of the multiple salary schedule system was only the first step in improving the State's compensation system. Our recommended changes to the Classification Plan (SAO Report No. 98-706) and recommended adjustments to the Classification Salary Schedules further bridge the gap between salaries across agencies and the external market. Only the cumulative effect of these two actions will place the State in a more competitive position compared to the market.

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Section 1:

## The State Is At Risk of Not Being Able to Attract and Retain Qualified Employees

Section 1-A:

### Loss in Real Earnings

On average, state employees have cumulatively lost \$5,438 in real earnings (purchasing power) since 1993. Inflation, as measured by the Consumer Price Index (CPI), has grown by 13.0 percent since 1993, while state employees' salaries have increased only 9.5 percent over the same period. (See Figure 1 for detailed information on inflation's effect on classified employee earnings.)

The CPI is generally the best measure for determining the amount necessary to allow employees to purchase, at today's prices, the same market basket of consumer goods and services that they could purchase in an earlier date.

Figure 1

Effect of Inflation on State Employee Earnings for Fiscal Years 1993-1998

Fiscal Year	May Average Annual Salary	Cumulative Percentage Increase in Salary	CPI Index	Cumulative Percentage Increase in CPI	Salary Needed to Maintain 1993 Real Earnings	Gain/(Loss) In Real Annual Earnings
1993	\$25,224		100.0			
1994	\$25,404	0.7	102.3	2.3	\$25,804	(\$400)
1995	\$25,620	1.6	105.5	5.5	\$26,611	(\$991)
1996	\$26,052	3.3	108.6	8.6	\$27,393	(\$1,341)
1997	\$26,124	3.6	111.0	11.0	\$27,999	(\$1,875)
1998	\$27,672	9.5	113.0	13.0	\$28,503	(\$831)
Total						(\$5,438)

Sources: U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index; State of Texas, Human Resource Information System, Classification Analysis for the Quarters Ending May 1993-1998.

Increases in the average annual salary of state employees has been due primarily to individual salary increases awarded through merits and promotions. Employee performance and enhanced skill levels are the basis for these types of increases.

Fiscal year 1998 showed the largest percentage increase in average state salary. Two main factors, other than merits and promotions, contributed to this significant increase. State employees received an across-the-board increase of \$100, which helped to lessen the loss in real earnings they experienced. However, the greatest contributing factor to the increase in average state salary involved positions that were previously exempt. In fiscal year 1998, a majority of these positions were incorporated into the Classification Plan (Plan). These positions typically consist of the highest paid positions in the state. Incorporating them into the Plan significantly increased the State's average classified salary.

While state employees have lost real earnings over the last five years; other employees in the market have actually gained real earnings based on salary structure increases.

Therefore, state employee salaries not only lost ground due to inflation, they have fallen even further behind salaries in the external market.

Section 1-B:

### Salary Structure Trends

To get a better picture of the State's competitive position within the market; an analysis of salary structure adjustments is necessary. State classified employees have not received salary structure adjustments in four of the last five years, and are not scheduled to receive an increase in fiscal year 1999. Nationally, salary structure adjustments ranged from 2.3 percent to 2.9 percent for each year since 1994. Moreover, other employers in the Central Texas area have increased their salary structures from 2.5 percent to 4.3 percent for each year since 1994. (See Figure 2 for detailed information on salary structure increases trends).

Figure 2  
Salary Structure Increase Trends

Type of Employees	1994	1995	1996	1997	1998	Cumulative Increase
<b>National Salary Structure Trends</b>						
FLSA Exempt	2.5%	2.4%	2.9%	2.7%	2.8% <sup>a</sup>	14.0%
FLSA Non-Exempt	2.4%	2.3%	2.8%	2.5%	2.7% <sup>a</sup>	13.4%
<b>Central Texas Salary Structure Trends</b>						
FLSA Exempt	2.8%	4.3%	3.6%	4.2%	3.9% <sup>a</sup>	20.3%
FLSA Non-Exempt	2.5%	3.9%	3.4%	4.1%	3.9% <sup>a</sup>	19.1%
<b>State of Texas Classification Salary Schedule Adjustments</b>						
Classified (both FLSA Exempt and Non-Exempt)	0.0%	0.0%	0.0%	0.0%	\$100/month approx.4.9% <sup>b</sup>	\$100/month approx. 4.9% <sup>b</sup>

Sources: American Compensation Association Salary Budget Survey and Austin Area Compensation and Benefits Directory/Austin Area Pay and Benefits Survey 1994-1998

<sup>a</sup>Projected

<sup>b</sup> This calculation is based on the average salary of employees who were classified as of August 31, 1997, and does not include the salaries of those previously exempt employees who were brought into the plan in fiscal year 1998. As a result, this estimated percentage increase is probably slightly higher than it should be.

The State primarily competes within the Central Texas market. Since 1994, the State has fallen at least 14.2 percent behind this market. The recommended 3.9 percent annual increase will maintain the State's relative position in the labor market in 1998, but will not improve the State's position. The recommended minimum of 3.9 percent only prevents the State from losing ground. To regain the State's 1994 position in the Central Texas market, the Schedules would need to be increased by 14.2 percent in fiscal year 2000 and 3.9 percent in fiscal year 2001, which would cost approximately \$1.3 billion for the biennium.

Since individual jobs have a relative worth compared to the market, it is not possible to quantify the State's overall position compared to the market. In some cases, jobs lag the market considerably while others meet or even exceed it. Salary structure

increases are an indicator of how the market is moving overall salary ranges for jobs. For the State to remain competitive, it must keep abreast of these types of increases. Otherwise, it tempts agencies to either misclassify positions to jobs in higher salary groups or promote employees before they have met the appropriate qualifications in an attempt to pay more competitively.

Section 1-C:

**Benefits**

The State should no longer rely on its employees' benefits package to narrow the gap between state employee salaries and private sector salaries for comparable jobs, especially for new state employees. State employees hired on and after September 1, 1995 are not eligible for benefit replacement pay of up to \$965.00 each calendar year. (Benefit Replacement Pay replaced the state-paid portion of employees' Social Security contributions granted to state employees hired prior to this date.)

As illustrated in Figure 3, benefits as a percentage of payroll for state employees have declined since 1995 while the national average has also declined, according to the U.S. Chamber of Commerce's 1996 survey of 802 public and private sector employees. Additionally, benefits as a percentage of payroll for employees ineligible for Benefit Replacement Pay (BRP) are now below the national average.

Figure 3  
Benefits as a Percentage of Payroll

Year	State Benefits as a Percentage of Payroll (BRP eligible)	State Benefits as a Percentage of Payroll (BRP ineligible)	National Average for Benefits as a Percentage of Payroll
1995	44.9%	N/A	42.0%
1996	44.1%	40.3%	41.3%

Figure 4 shows the decline in benefits by area. These reductions contribute to the State's reduction in benefits as a percentage of payroll.

Figure 4  
Declining State Benefits Category Trends

Year	Life, Accident, and Health	Unemployment Compensation
1995	12.1%	0.5%
1996	11.4%	0.3%

As a result of declining benefits for state employees, the competitiveness of state salaries takes on added importance in the State's ability to attract and retain qualified employees.

Section 1-D:

### Employee Turnover

The statewide turnover rate for fiscal year 1997 was 14.27 percent, based on an average of 131,014 full-time classified state employees and a total of 18,699 full-time classified terminations. Of those terminations, 1,976 employees cited inadequate salary as the reason for leaving state employment.

Significant costs arise from agencies having to recruit, hire, and train new staff. According to the *Retention and Staffing Report* by Manchester Partners International, recruitment efforts to fill a vacant position cost between \$5,000 and \$10,000 in 1998.

These costs may include:

- A decrease in productivity
- The actual cost of hiring a new employee
- An increase in training time

Other problems related to turnover can include:

- Decreased efficiency and continuity of operations
- Low employee morale
- Difficulty in replacing departed employees

Using these estimates, turnover cost the State between \$93,495,000 and \$186,990,000 in 1997. The employees who left the State in 1997 due to inadequate salaries cost the State between \$9,880,000 and \$19,760,000.

Inadequate salary appears to be a significant factor in the statewide turnover rate. Classified employees resigning because of inadequate salary were 9.42 percent of total terminations in fiscal year 1997, an increase from 6.47 percent in fiscal year 1996 and 8.54 percent in 1995. Inadequate salary moved from the third most commonly stated turnover reason in 1995, to the second most commonly stated turnover reason in 1996 and 1997, excluding interagency transfers.

The main reason for agency terminations in fiscal year 1997 was “Personal reasons not related to the job.” The employee reports this information and it is likely that compensation was a factor in the decision to leave state employment.

Figure 5 illustrates Texas' turnover as compared with national and Central States averages.

Figure 5  
Turnover Rates

Fiscal Year	State of Texas Classified Turnover Rate	National Turnover Rate	Central States Turnover Rate
1997	14.27%	13.20%	11.73%
1996	13.64%	10.80%	11.66%
1995	13.51%	12.00%	12.30%



Additionally, we reviewed local turnover data from the Central Texas region. This region contains the largest percentage of the State's full-time classified employees and is considered the primary market within which the State competes for its classified employees. Turnover for full-time classified employees appears to be in line with local turnover averages. In 1997, Travis County (County) had a turnover rate of 15.30 percent and the City of Austin (City) had a turnover rate of 14.08 percent. The County, which employs about 3,600 employees, is making strides to retain its employees by paying market rates. Effective January 1997, the County approved \$13.7 million to be allocated over a two-year period towards salary increases. City employees received a 3 percent across the board increase in 1996. In 1997, the City approved a pay-for-performance system which gives a 5 percent increase to employees who exceed expectations, 3.5 percent to employees who meet expectations, and nothing to employees whose performance is below expectations.

Section 1-E:

### **Economic Outlook**

The State of Texas as a whole has experienced a strong economy in recent years, as depicted in accelerated job growth and declining unemployment rates. This trend is expected to continue through the turn of the century. Specifically, the economic outlook for the Austin area indicates growth rates that remain well above national and state rates. Austin is expected to lead the State in job growth through the end of the century. This information is most compelling since the Austin area contains the largest percentage of the State's full-time classified employees. It is considered the primary market within which the State competes for its classified employees.

The State's increasing turnover rate is the result of the state's stronger economy. However, the State can no longer rely on a competitive compensation package to attract and retain quality employees. Benefits (as a percentage of payroll) have declined and there have been no salary structure adjustments in four of the last five years. To maintain its relative position in the labor market, the State should focus on increasing base pay and adjusting the Schedules as recommended. The State cannot afford to maintain the current salary rates because of the strong economy and costs associated with turnover.

Section 2:

## **A Percentage Increase Will Increase Competitiveness of Professional and Managerial Salaries More Than a Flat-Dollar Increase**

### **Percentage Versus a Flat-Dollar Increase**

Historically, the market pays more than the State for professional and managerial positions, while the State pays the same or more than the market for administrative support, maintenance, service, and technical positions. A percentage increase would reduce the pay gap for professional and managerial positions more than a flat-dollar increase. In contrast, a flat-dollar increase will target those positions whose salaries are already competitive with the market. To recruit and retain crucial professional and

managerial positions, a percentage-of-salary increase is necessary to affect the work force whose salaries are least competitive with the market. A percentage-of-salary increase will enable the State to maximize its return on investment by focusing scarce resource dollars where they are needed: professional and managerial positions.

Our Office has calculated the cost of increasing the salary schedule structures using both methods (percentage increase and flat-dollar increase). We believe a percentage increase is preferable, as outlined below.

Figure 6  
Pros and Cons of a Percentage Versus a Flat-Dollar Increase

	Percentage Increase	Flat-Dollar Increase
<b>Pros</b>	<ul style="list-style-type: none"> <li>• Targets professional and managerial positions whose salaries are the farthest behind the market.</li> <li>• Maintains appropriate differentials between supervisors and the employees whom they supervise.</li> </ul>	<ul style="list-style-type: none"> <li>• Lower overall cost for the biennium.</li> </ul>
<b>Cons</b>	<ul style="list-style-type: none"> <li>• Higher overall cost for the biennium.</li> </ul>	<ul style="list-style-type: none"> <li>• Targets administrative support, maintenance, service, and technical positions whose salaries are, for the most part, more competitive with the market.</li> <li>• Creates salary compression between supervisors and the employees whom they supervise.</li> </ul>

Last biennium, the Legislature provided a \$100 per month flat-dollar increase for fiscal year 1998 rather than a percentage-of-salary increase. A flat-dollar increase of \$89.00 per month for each year of the 2000-2001 biennium is approximately equal to the statewide cost of providing a 3.9 percent increase.

## Objective, Scope, and Methodology

The State Classification Office (Office) in the State Auditor's Office conducts periodic studies of salary rates and trends in industry and other governmental units for work similar to that performed in state government. The Office is required to report these findings and make recommendations for adjustments to the Classification Salary Schedules (Schedules). This report examines general salary trends, discusses other factors that influence salaries, and provides recommendations for adjustments to the State of Texas' Schedules.

In developing our recommendations, the Office analyzed.

- Inflation rates
- National and regional salary structure trends for both the private and public sector
- The State's total compensation package for classified employees
- Classified employee turnover trends
- Economic factors

To determine inflation's effect on state employee earnings, we used the May average salary for fiscal years 1993-1997. This average salary included both classified and exempt employees so it is consistent with the one for fiscal year 1998. As of September 1, 1997, the majority of formally exempt titles were moved into the classification schedules while establishing the multiple salary schedule system.

The salary structure trends were based on data from the American Compensation Association (ACA) Salary Budget Survey and Austin Area Compensation and Benefits Directory/Austin Local Area Pay and Benefits Survey.

The ACA Salary Budget Survey contains data from over 2,800 U.S. firms, representing a broad cross-section of industries including: public administration, financial, insurance, real estate, communications, service, utilities, transportation, manufacturing, and wholesale and retail trade industries.

The Austin Area Compensation and Benefits Directory/Austin Area Pay and Benefits Survey represents data from government, high technology, manufacturing, health care, and service industries.

The employee benefits calculations include vacation leave, sick leave, holidays, worker's compensation, insurance, Benefit Replacement Pay, retirement, and unemployment compensation.

For analysis purposes in this report, we used 1996 data on the State's benefits package to match the latest available benefits data from the U.S. Chamber of Commerce. However, the State's benefits package for employees eligible for Benefit Replacement Pay dropped to 42.8 percent from 44.1 percent of payroll in 1996.

This review was conducted in accordance with the Position Classification Act, Texas Government Code, Chapter 654, by the following members of the State Auditor's staff:

- Juliette Torres, CCP, PHR (Project Manager)
- Sharon Schneider, PHR
- Kelli Dan, CCP, PHR (Audit Manager)
- Craig Kinton, CPA (Director)

## Cost Estimates

Figure 7 shows the estimated annual costs to implement the percentage rate and flat-dollar rate increases. The estimates are based on the average monthly salary of \$2,273 for 146,113 classified employees as of May 31, 1998. They do *not* include the cost of additional state-paid retirement contributions or benefit replacement pay for eligible employees.

The estimates also do not include the cost of providing increases to employees exempt from the Classification Plan or employees in institutions of higher education. Since we did not review the salaries of employees exempt from the Classification Plan or employees in institutions of higher education, we cannot report on the competitiveness of these employees' salaries in relation to the labor market.

Figure 7  
Estimated Annual/Biennial Cost of Increases

	Fiscal Year 2000		Fiscal Year 2001		Biennial Total	
	3.9%	\$89/Month	3.9%	\$89/Month	3.9%	\$89/Month
Classified Employees	\$155,429,749	\$156,048,684	\$316,921,259	\$312,097,368	\$472,351,008	\$468,146,052

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