Senate Special Committee
on
State Employee Compensation and Benefits

Report and Recommendations
to the 78th Legislature

January 2003

Senate Special Committee on State Employee Compensation and Benefits

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SENATOR GONZALO BARRIENTOS
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January 13, 2003

The Honorable Bill Ratliff
Lieutenant Governor of Texas
P.O. Box 12068
Austin, Texas 78711

Dear Governor Ratliff:

The Senate Special Committee on Employee Compensation and Benefits respectfully submits this report to the 78th Texas Legislature on the assigned interim charge.

Respectfully submitted,

Senator Jeff Wentworth, Chair

Senator Gonzalo Barrientos, Vice-Chair

Senator Jon Lindsay

Senator Todd Staples

Senator John Whitmire

Mr. Gary Anderson, Public Member

Mr. Roger Williams, Public Member

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January 21, 2003

Senator Jeff Wentworth, Chairman
Senate Special Committee on State Employee Compensation and Benefits
P.O. Box 12068
Austin, TX 78711-2068

Dear Senator Wentworth:

Thank you for your leadership and dedication on the Senate Special Committee on State Employee Compensation and Benefits. The report includes a number of strong recommendations.

I have signed the report. However, I do not support the recommendation to adjust targeted co-pays to generate savings in the state's health insurance program.

Thank you again for your hard work and service to the people of Texas.

Sincerely,

Gary W. Anderson
Executive Director

Cc Senator Gonzalo Barrientos, Vice-Chair
Senator Jon Lindsay
Senator Todd Staples
Senator Todd Whitmire
Mr. Roger Williams, Public Member

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REPORT OF THE SPECIAL SENATE COMMITTEE
ON
EMPLOYEE COMPENSATION AND BENEFITS

Pursuant to the charge of Lieutenant Governor Bill Ratliff, the Special Senate Committee on Employee Compensation and Benefits ("the Committee") was created. The Committee is comprised of five members from the Texas Senate and two public members: Senator Jeff Wentworth, Chairman; Senator Gonzalo Barrientos, Vice Chairman; Senator Todd Staples; Senator Jon Lindsay; Senator John Whitmire; Mr. Gary Anderson; and Mr. Roger Williams. The Committee was charged with the review of several employment issues within state government, including the state's Classification System, retention of state employees, cost of employee benefits, retirement benefit options, contributing factors to salary disparities between state employees and private industry employees, and the valuation of the merit-based compensation system.

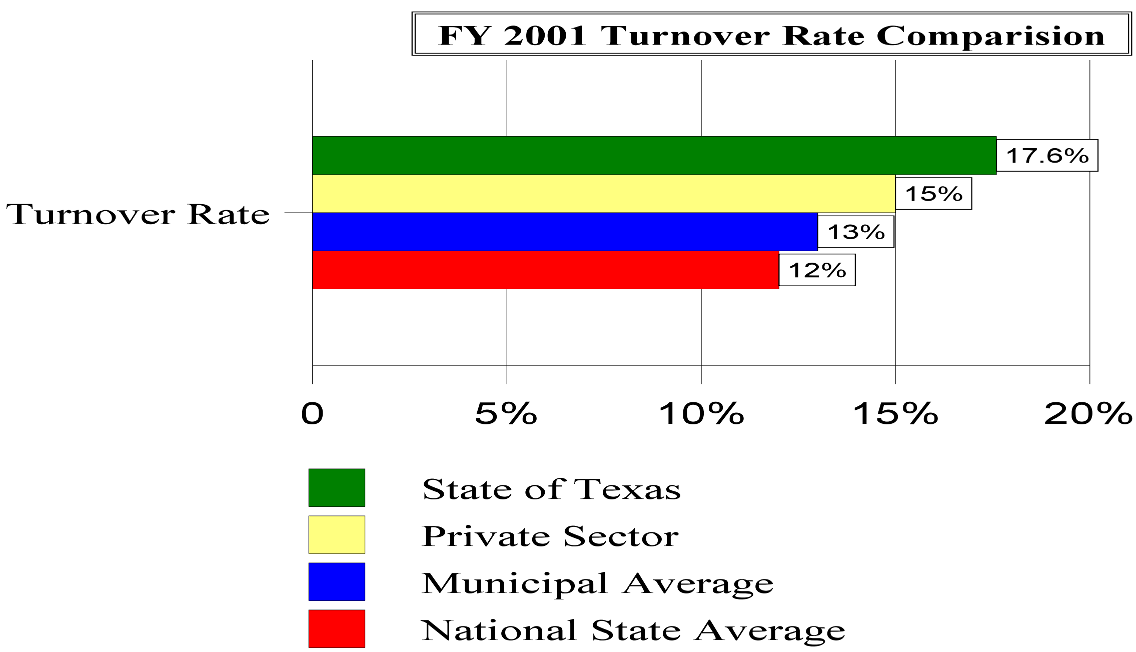
Notices of hearings were sent to all interested parties. The initial hearing was held in Austin, on July 23, 2002, in the Capitol Extension Room E1.028. The Committee met and accepted both written and oral testimony from Ms. Michelle Smith of the Texas State Employees Union; Mr. Andrew Homer representing the Texas Public Employees Association; Mr. Brian Hawthorne of the Department of Public Safety Officers Association; Mr. Oran McMichael of the American Federation of State, County, and Municipal Employees Union; Mr. Chuck Hempstead of the Texas Association of College Teachers; Dr. Charles Zucker of the Texas Faculty Association; Mr. Mike Higgins of the Texas State Association of Fire Fighters; Mrs. Kelli Vito and Mr. Tony Garrant both representing the State Auditor's Office; Ms. Sheila Beckett from the Employees Retirement System of Texas; Mr. Donald Dickson from the Texas State Troopers Association, and Mr. Stuart Greenfield. Representatives from state agencies and boards were also in attendance as resource witnesses. They included Ms. Rita Horwitz from the State Pension Review Board; Mr. Ken Welch of the Office of Comptroller of Public Accounts; Ms. Vicki Smith of the Office of Comptroller of Public Accounts; and Mr. Wade McDonald with the Legislative Budget Board.

The Committee held a second meeting in Lufkin, Texas, the location of which was recommended by Senator Todd Staples, on December 13, 2002, in the Lufkin City Council Chamber. The Committee accepted written and oral testimony from the Honorable Jim McReynolds, Texas State Representative; Ms. Terry Cantrell with the Texas State Employees Union; Mr. Bobby Young from the Texas Forest Service; and Mr. Larry King, representing the Texas Association of College Teachers. Resource witnesses in attendance were Mrs. Kelli Vito with the State Auditor's Office, Mr. Ray Hymel of the Employees Retirement System of Texas, and Mr. Wade McDonald with the Legislative Budget Board.

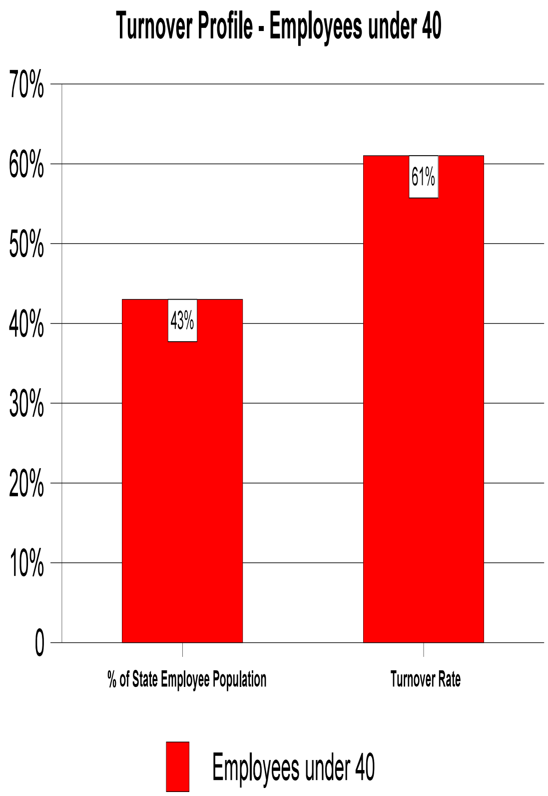
PART ONE: SUMMARY OF BACKGROUND INFORMATION

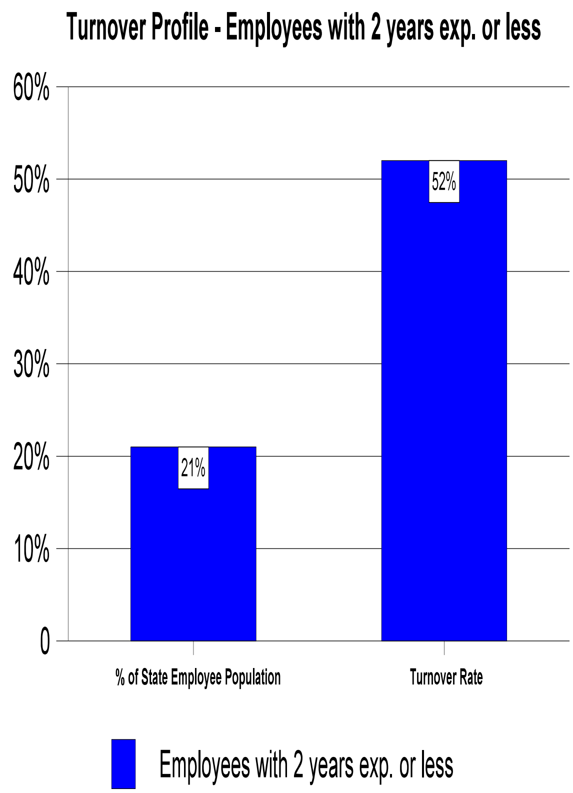
Employee Turnover

The State Auditor's office estimates the turnover rate for FY 2002 is just under 15%, and will be releasing a final number by January 2003. In 2001, the State Auditor's office reported a 17.6% turnover rate among employees of the State of Texas. The FY 2001 turnover rate decreased slightly from 2000 levels (18.9%), but still exceeds the national state average (12%), the average for local municipalities (13%), and the private sector average (15%).



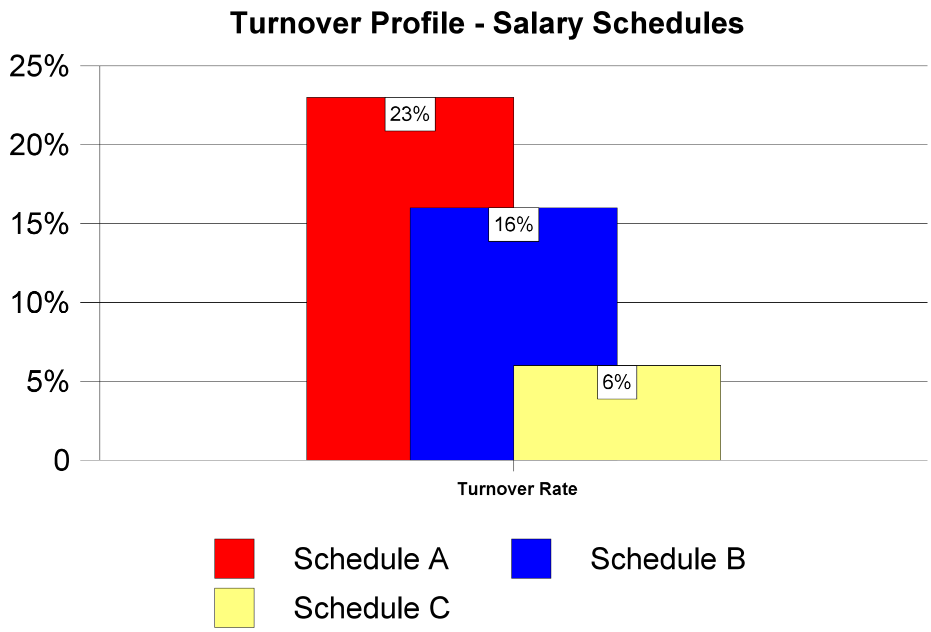
Human Resource profiles indicate that a majority of those employees leaving state jobs share two distinct hallmarks: 1) the employees are under the age of 40, and 2) the employees' length of service with the state is two years or less. By themselves, these demographics may be of only passing interest, yet when the size of these two groups compared to their high turnover rates is considered, it is apparent that there is a problem. State employees under age 40 constitute 43% of the employee population, yet they represent 61% of the state's employee turnover. Likewise, state employees with less than two years experience account for only 21% of the employee population, but constitute approximately 52% of the state's turnover rate.





High levels of employee turnover are very expensive. The estimated costs related to employee turnover in the state of Texas are estimated at **$254 million** to **$1.1 billion**. One example of a turnover cost is the loss that results from both initial and replacement employee hiring and training. Once an employee is hired, it usually takes approximately six to eight months to train that employee. During this time, the employee often requires more agency resources than he or she is able to generate. When a high number of new employees leaves within the first two years, Texas taxpayers are burdened with the costs of hiring and training the original employees, plus the additional costs of hiring and training the replacement employees as well.

Below is a graph that illustrates the current average turnover rates in all state agencies (all numbers rounded):



Voluntary/Involuntary Termination

According to employee data collected in 2000, the State Auditor's office reports that almost half of the employees terminating service with the state chose to leave for either "personal reasons not related to the job" or "reasons unknown." In recognition of the need to understand more clearly why employees choose to leave state service, the 77th Texas Legislature passed Senate Bill 799 which requires the State Auditor's office to develop a more specific on-line employee exit survey. The survey not only offers insight into the top reasons for employee departure from the state, but also provides an opportunity for employees to provide feedback to state agencies and the Legislature. This survey information is provided to the human resource directors and executive directors of each agency on a quarterly basis, and the Governor and Legislature on an annual basis. The first quarterly report for fiscal year 2002 indicates the top reasons for leaving state employment were:

- Better pay/benefits
- Retirement
- Personal and family health
- Issues with my supervisor/issues with employees I supervise
- Poor working conditions/environment

Furthermore, the survey indicates that those leaving are choosing the following career paths:

- Seeking other employment/leaving the agency
- Taking a job in the private sector
- Transferring to another Texas state agency
- Taking a job with another governmental organization

Thirty-two percent of the respondents indicated that his or her salary will increase at the new job. Of all departing workers, the highest percentage (14.7%) indicate that their salary will increase $5,000 or more annually at his or her new job. When asked what they would like to change at the agency, respondents reported:

- Employee/management relations
- Compensation/benefits
- Employee rewards/recognition
- Agency's internal policies/procedures

***Employee Retirement*: Loss of Institutional Knowledge**

In addition to voluntary/involuntary employee termination, the state is losing large numbers of employees due to retirement. The loss of retirees places the state in the difficult position of attempting to replace intangible employee assets such as deep institutional knowledge and senior staff experience. With the large number of employees leaving within the first two years of state employment, the pool of qualified replacements for those retiring is becoming increasingly smaller.

As an example of the scope of these losses, The Employee Retirement System of Texas (ERS) reports that between 1997-2001, 13,976 state employees retired. In 2002 alone, there will be 11,593 employees eligible to retire. Cumulatively, the state is expected to have approximately 23,338 employees eligible to retire by 2006. The state currently employees 143,288 people. Therefore, by 2006, over 16% of the current workforce will be eligible for retirement. In total, the state is projected to have lost over 37,000 employees from 1997-2006. Currently, the average employee age at the time of retirement is 60.2 years, with an average service to the state of 23.1 years.

The State Auditor's Office has indicated that the state's inability to compensate for the loss of its most knowledgeable employees could handicap the governments's ability to function smoothly and to deliver adequate services.

Compensation and Benefits System

The current philosophy underpinning the structure and maintenance of the state's compensation package is that it should be competitive in the market, yet it should not lead the market. The state's employee compensation system comprises four primary elements:

- **Salary**
- **Performance/Merit/Bonus pay**
- **Insurance**
- **Retirement**

Salary

All state employees, except those working for the Legislature, are classified by salary group: Schedule A, Schedule B, and Schedule C (law enforcement). Salary Schedule A primarily includes administrative support, maintenance, service, technical, and paraprofessional positions. Salary Schedule B primarily includes professional and managerial jobs. Salary Schedule C covers the majority of Texas Commission on Law Enforcement Officer Standards and Education (TCLEOSE) certified law enforcement positions at the four primary law enforcement agencies.

The most current snapshot of the compensation system is found in the latest report from the State Auditor's Office entitled *Biennial Report on Recommended Changes to the State's Compensation System for Fiscal Years 2004-2005*. Released in September of 2002, this report reevaluates the philosophy and the structure of the state's compensation system and offers several fundamental refinements to the system that the Legislature may choose to adopt. The report suggests that the state's compensation structure and salary ranges are generally "market competitive"– meaning competitive with other government entities and with private industry.

The Auditor's office compared 88 benchmark jobs within Salary Schedules A and B to similar jobs in the public and private sectors to determine market competitiveness. According to the Biennial Report, "The State Classification Office (SCO) **considers a salary schedule generally competitive if the midpoints are within 10 percent of the job market on average.** The midpoint in a salary range is meant to correspond to the average pay in the job market."

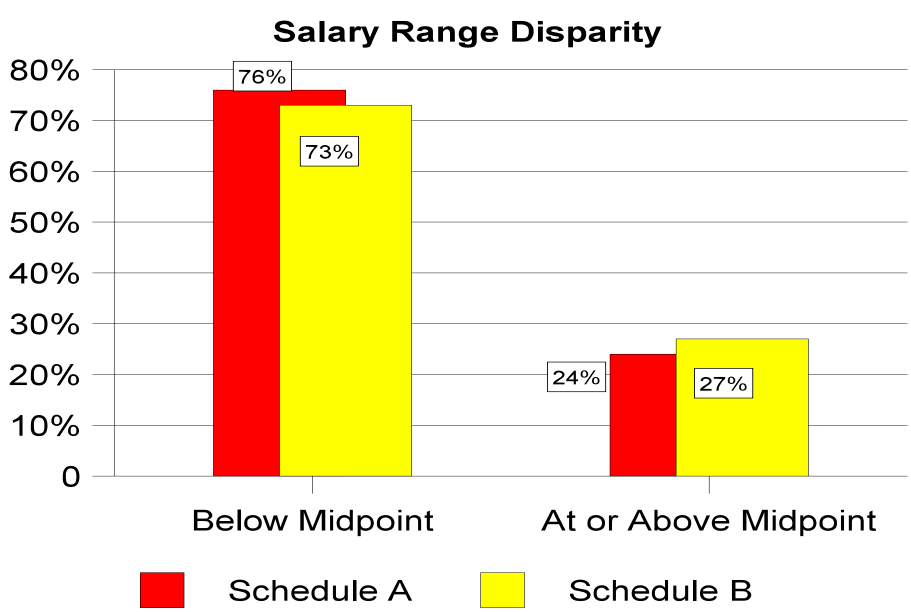
Of the 88 benchmark jobs, 38 were in Schedule A, and 50 were in Schedule B. Data from the study indicates that only 34% of the benchmarked jobs were within five percent of the market average. Furthermore, seven percent of the benchmark jobs were 20% *or more* behind the market. Although the Auditor's office declared these benchmark jobs market competitive, they also note that state employees' salaries fall below market salaries for comparable work by an average of 14%.

Thus, while the Auditor's Office reports that the salary structure itself and the particular salary ranges that constitute the structure are market competitive, the payday reality for employees suggests another story: *Actual employee pay is far behind the market by any common means of comparison.*

One of the reasons for this employee pay problem is the "10% salary range lag" philosophy noted above, which raises several important questions. First, staff research has found no mention of the 10% lag in any of the Auditor's previously released public documents. If this lag has not been a fundamental element of the Auditor's salary philosophy in the past, why must it be so now? Secondly, when the state is finding it difficult to attract and retain a well-qualified workforce, why must the state employee salary ranges lag the market at all? Assuming that the salary ranges must lag the market, why trail by a number as high as 10%? Also, since the Auditor's office uses the midpoint as the comparative measure of competitiveness, what is the effect of the 10% lag on the midpoint itself, and how does that effect the employee's actual pay? As we will see, this 10% market lag actually reflects an approximate ***20% to 30% lag*** when combined with other factors.

Another reason for the pay problem is the paradox of a system that offers a competitive ***structure*** yet delivers uncompetitive ***actual salaries***. How could such a system exist? Perhaps the answer lies in the use of the midpoint comparison model itself. This model can only determine whether or not state employees' salary *ranges* are competitive with the market. Yet when most employees are paid well below the actual salary range midpoint, the midpoint does not function as a legitimate indicator of the market competitiveness of salaries–it can only describe a system. **Currently, 76% of all Schedule A employees are paid below the midpoint of the salary range with only 24% at or above the midpoint. Likewise, 73% of all Schedule B employees are paid below the midpoint of the salary range with only 27% at or above the midpoint.**

The numbers below represent *all* employees within Schedules A and B, rather than only the benchmarked employees from the biennial report.



Therefore, it appears that a midpoint comparison may be used effectively only when determining the adequacy of the State Classification Office's salary schedules and nothing more. The midpoint analysis data is irrelevant for determining appropriate levels of state employee compensation. However, it should be remembered that even within the state's *own system*, flawed though it may be, the vast majority of state employees are payed below the midpoint levels.

Perhaps it would be helpful to use a more accurate model of comparison when attempting to gauge market competitiveness – one that gives an actual representation of market realities. We believe that comparing **actual average state employee salaries** to similar average salaries in the market is the only proper methodology for determining appropriate levels of employee compensation.

(*The table below demonstrates how the Midpoint Analysis Data does not give a true representation of actual market competitiveness)*

	Midpoint Analysis Data	**Average Salary Data**
% of Benchmark Jobs within 5% of Market	34%	8%
% of Benchmark Jobs 20% ***or more*** Behind Market	7%	19%

Clearly, the two sets of numbers tell quite different stories. The Average Salary Data figures demonstrate more accurately how far state employee salaries truly trail the market. Meanwhile, the numbers below show in actual FY 2002 dollars the difference between state government salaries and market salaries paid for similar work: Of the 38 benchmark jobs in Schedule A, on average, employee pay was 12.3% behind the market. Of the 50 benchmark jobs in Schedule B, on average, employee pay was 15% behind the market.

	State Benchmark Average Salary FY 2002	Market Average Salary FY 2002
Schedule A	**$26,881**	**$30,857**
Schedule B	**$43,619**	**$51,248**

Although the salary disparities have continued to grow, state employee pay raises have been sporadic. Employees have not received consecutive-year pay raises since FY 1992 and FY 1993 – a full decade ago. During the four fiscal years of 1994 through 1997, state employees received no across-the-board pay raises. In total, over the past ten years, state employees have received only three across-the-board pay raises – once in the first year of each of the past three biennia.

The following table represents a historical perspective on the percentage increase in classification salary schedules by fiscal year 1970-2001.

Fiscal Year	Percentage Increase	Fiscal Year	Percentage Increase
1970	6.8%	**1987**	0.0% **(e)**
1971	3.4%	**1988**	0.0%
1972	6.8% **(a)**	**1989**	2.0% **(f)**
1973	6.8%	**1990**	5% or $60 **(g)**
1974	6.8 – 10.2% **(b)**	**1991**	0.0%
1975	3.4%	**1992**	3.0% **(h)**
1976	13.6 – 17% **(c)**	**1993**	3.0% **(h)**
1977	6.8%	**1994**	0.0%
1978	3.4%	**1995**	0.0%
1979	3.4%	**1996**	0.0%
1980	5.1%	**1997**	0.0%
1981	5.1%	**1998**	$100 **(i)**
1982	13.6 – 18.2% **(d)**	**1999**	0.0%
1983	8.7%	**2000**	$100 **(j)**
1984	4.0%	**2001**	0.0%
1985	3.0%	**2002**	4% or $100 **(k)**
1986	3.0%	**2003**	3.0% **(l)**

a. The classified salary schedule was adjusted upward by 3.4 percent. The additional 3.4 percent increase came from all employees moving forward one salary group.

b. Salary groups 2 through 7 received a 10.2 percent increase, in addition to a 3.4 percent longevity increase for employees with five or more years of continuous service. Salary groups 8 through 21 received a 6.8 percent increase.

c. Two separate increases were made in 1975. Salary groups 2 through 12 received a 17 percent increase. Salary groups 13 through 21 received a 13.6 overall increase.

d. Two separate increases were made in 1981, the first, effective February 1, 1981, granted a 5.1 percent increase with a guaranteed raise of $50 per month. The second increase took effect September 1, 1981 (the first day of fiscal year 1982), and provided for a raise of 9.2 percent with a $50 a month minimum. This 9.2 percent increase, when combined with the $50 minimum granted in February, results in a total increase of 18.2 percent for the lowest paid employees. For employees receiving more than the $50 minimum, the increase varied from 13.6 to 14.2 percent.

e. The Appropriations Act for this fiscal year included a 3.0 percent salary increase for state employees. The 69th Legislature in the 3rd special session reduced this to 0.0 percent due to the revenue shortfall Texas was experiencing.

f. This salary increase was given upon the Comptroller's certification that enough revenue existed to award this increase.

g. All rates increased by 5.0 percent or $60 a month maximum.

h. Section 146 of the FY 1992-93 Appropriations Act (HB 1, 72nd Legislature, 1st C.S.) gave the Comptroller the authority to provide a 3% salary increase each year of the 1992-93 biennium. The Comptroller provided a 2% increase beginning FY 1992 and a 1% increase at the end of FY 1992. A 3% increase was provided FY 1993 on December 1, 1992.

i. Employees of state agencies, non-faculty employees of institutions of higher education, and employees of the Higher Education Coordinating Board received $100 per month salary increase.

j. Except for Schedule C employees and exempt employees, employees of state agencies, non-faculty employees of institutions of higher education, and employees of the Higher Education Coordinating Board received a $100 month salary increase. Schedule C was revised completely; employees received varying salary increases.

k. State employees with at least 12 months continuous service as of 9/1/01 were granted the greater of a 4% or $100 monthly increase except for certain employees of TDCJ and TYC who received targeted increases. New employees will receive the increase at three "catch-up" points during the biennium. In addition, the number of years used to calculate longevity pay was reduced from five years to three years.

l. Subject to a finding by the Comptroller that sufficient funds are available, a contingent raise was granted for FY 2003 of 3% with a $65 monthly minimum for all scheduled employees. Thus far the Comptroller has indicated that it is unlikely that sufficient funds for this contingent raise will be found and certified.

Overall, it is clear that state employee salaries have become significantly less competitive relative to those offered by the market. Yet, the situation does not appear to be improving – on the contrary, it projects to become worse. For example, during the past several years salary budgets in the private sector have increased by 4 percent and are projected to increase by 4 percent for 2003. If this growth trend continues, and if there is no statewide pay increase next biennium, state employee salaries would be, ***on average***, ***22 percent behind the market by the end of the 2004-05 Biennium.***

So, instead of having a significant percentage of state employee salaries 20 percent or more behind the market, there may be a significant percentage of state employee salaries ***30 percent or more behind the market***.

In an attempt to clarify the elements of the salary discussion, perhaps it would be best to summarize the information and describe it in a simple concept – "The Triple Whammy Effect." An example of this phenomenon follows:

“THE TRIPLE WHAMMY”

1. Employee salary midpoints are allowed to lag the market by a substantial amount (as found in the Auditor’s Office’s “10% Lag Rule”);

2. The vast majority of agency employees (75%) are paid a substantial amount below the State structure’s own salary midpoints; and

3. State Employees are given little or no increases in pay over a number of years while other employers in the market steadily raise their employees’ salaries.

So, if an average State Employee, Bob Smith, were to be hired by with a state agency today, his salary is almost assured to be lower than the market because of the 10% midpoint lag philosophy.

Therefore, we will subtract: **- 10%**

Now, there is a 75% percent chance that Mr. Smith will be paid approximately 10% below the midpoint of his own salary range. According to estimates by the Legislative Budget Board (LBB), the average Schedule A or B employee is paid at a level roughly 10% below midpoint. In fact, the average salary in Schedule A is only 6% above the *minimum* of the range. Meanwhile, the average Schedule B salary is only 10% above the *minimum* of the range.

Therefore, we must subtract another: **- 10%**

Over the next several years (2003-2005), Mr. Smith’s counterparts in the private and public sectors will receive an average annual pay increase of 4%. If, as might be the case, the Texas Legislature does not approve a pay raise for the next biennium, (remember, there is no pay raise for 2003) Mr. Smith’s salary will fall approximately 12% further behind the market.

Therefore, we must subtract another: **- 12%**

TOTAL - 32%

So, if we total the amounts subtracted, we find that Bob Smith's salary will be trailing his market counterparts by approximately **32%** by 2005. Since these numbers are based on average salaries, an argument could be made that some employees are paid at a level much closer to that of the market average – which would be correct. But it must also be true, however, that many employees are paid **much lower** than the average numbers listed above. It is clear then that, barring a pay raise for Fiscal Years 2003-05, roughly half the State of Texas' employees could be paid ***32% or more below the market***.

Obviously, these large disparities in compensation levels will contribute to the decline of the overall workforce environment. As the economy recovers and private sector jobs become more plentiful and more lucrative, it is inevitable that many state employees will leave for greener pastures. The end result will be higher turnover rates, increased employee dissatisfaction, and an increased burden on the state to do more with less.

Pay for Performance

The State of Texas offers salary increases using a system of merit increases, pay for performance raises, incentive programs, and one-time merit bonuses. The pay for performance system is comprised of:

- **Performance Rewards** - an agency, as a whole, must meet program goals and objectives in order to receive rewards that can then be passed down as enhanced employee compensation. The Auditor reports that in fiscal year 2001, only ten out of 130 state agencies met their performance targets and were thereby qualified to offer performance awards to their employees. Out of these ten qualified agencies, only two agencies actually rewarded performance pay awards to their employees. Thus, only two out of 130 agencies or 1.5% of all agencies gave performance pay.

- **Incentive Program** - a reward given to an employee who gives a suggestion for improvements which results in an overall savings or revenue increase to the agency and, ultimately, to the people of Texas. An employee receives a reward based upon savings (10% of savings or increased revenue, up to $5,000) or $50 if a suggestion is ineligible for a cash award. According to the Auditor's office, the employee Incentive Program has received 9,888 suggestions submitted over a twelve year period, with an overall savings to the state of $19,263,120. Over the same twelve years, $422,176 has been paid to 390 employees in cash awards.

- **Merit Increases** - increase of an employee's salary within a salary group, based on the employee's performance while doing his or her job.

- **Merit Bonuses** - a one-time cash bonus that does not raise the employee's salary within the structure.

The State Auditor's Office provided the following statistics which indicate the total number of employees who received a merit increase, as well as the percentage of total employees who received a merit increase:

Merit Increases for FY 2001 and FY 2002

Schedule A

Fiscal Year	Total # of Employees	Number of Merits Awarded	Percentage of Merits Awarded	Number of One Time Merits Awarded	Percentage of One Time Merits Awarded
2001	65,584	12,520	19.1%	1,093	1.7%
2002	78,372	7,575	9.7%	1,388	1.8%

(continued next page)

Schedule B					
Fiscal Year	**Total # of Employees**	**Number of Merits Awarded**	**Percentage of Merits Awarded**	**Number of One Time Merits Awarded**	**Percentage of One Time Merits Awarded**
2001	59,402	18,426	31.0%	2,054	3.5%
2002	56,831	8,764	15.4%	2,355	4.1%

In an effort to address perceived shortcomings in the State's merit system, the 77th Legislature passed House Bill 2914 which created the Employee Compensation System Evaluation Task Force (Sec. 659.2552). Under the State Auditor's direction, the Task Force is comprised of state agency leaders and human resource professionals from large, medium, and small agencies. The Task Force was charged with evaluating the strengths and weaknesses of the current merit system. After several meetings and fact-finding studies, the Task Force released an official summary that offers a detailed analysis of the state's merit system. This information is contained in a report entitled: ***Pay-for-Performance - A Report on The Texas Employee Compensation System***.

In the report, the Task Force found that "a fully implemented pay-for-performance system would improve the State's ability to respond to the public service needs of Texas citizens." The report further states that although the current merit system has the proper *components* available to make it effective, it "is ***not*** an effective pay-for-performance system, primarily because it is not funded adequately."

Funding for the pay for performance system is not currently available to agencies under the Appropriations Act. Instead, each agency's budget must absorb the costs of rewarding employees under the pay-for-performance system, while continuing to deliver all of the agency's normal services. Unfortunately, the current system may actually deter agencies from giving merit raises in an effort to maintain service levels.

In addition to a lack of proper funding, the Task Force found that the system is not applied consistently throughout the State agencies. The report states that only 28% of employees received merit increases in FY 2001, with one-time merits awarded to 2.7% of employees in FY 2001 and 4% of employees in FY 2002. Excluding correctional officers, one-third of all state employees worked in an agency that awarded *merit increases* to less than 15% of its employees in FY 2001. More than half of our state employees are at agencies that awarded 15% or fewer *merit raises*, leaving most employees having little or no hope of ever getting a merit raise.

The inability or unwillingness of each agency to use the merit system as it is intended creates a negative impact on its own employees. The Task Force found that the lack of merit raises/bonuses coupled with the dearth of meaningful or effective across-the-board pay raises results in growing employee dissatisfaction and, ultimately, higher agency turnover rates. In sum, agencies not rewarding high-performing employees risk losing them, and when the State loses these top employees, the entire culture and effectiveness of the workforce is jeopardized.

***Benefits* - Health Insurance and Retirement**

The State of Texas' insurance coverage programs and retirement program are considered to be very market competitive. With regard to insurance, the state offers paid Health, Life, Accidental Death and Dismemberment. Optional coverage to be paid by the state employee includes Voluntary Accidental Death and Dismemberment, Dental, Vision, and Long-term Care. These insurance policies cover the state employees and their dependents, state retirees and their dependents, and higher education employees and retirees plus their dependents. The University of Texas and the Texas A&M University systems are not covered under the same system.

Health insurance is paid at a rate of 100% for state employees and retirees. However, each employee or retiree pays 50% of the costs for his or her dependents. An individual may select from the following provider options: **Health Select** (in and out of network options), **Health Select Plus** (in network option only) or a commercial **HMO**. Currently, all state employees receive insurance coverage immediately upon hiring, and are not required to undergo any waiting period.

The Employees Retirement System (ERS) reports in their Legislative Appropriations Request a need for funding to cover health plan costs (assuming current benefit levels) of **$3.1 billion** for **FY 2004-05**. This translates into an increase of $715.5 million (29.9%), from the previous biennium with $437 million needed from General Revenue. ERS states a steady increase in total health plan expenditures. Fiscal year 2002, expenditures are estimated at totaling **$1.4 billion**, a **15.7% increase** since FY 2001. Likewise, ERS estimates a 26% increase in both the state and employee's contribution to the health insurance plan.

The ERS reports that these large-percentage-cost growths are due to increases in the cost of services, increases in utilization of services, higher hospitalization costs, rising prescription drug costs, and HMO management factors. Over the past ten years, the state has implemented several cost containment initiatives such as generic drugs, higher co-payments, and freezing enrollment in Health Select Plus excluding metropolitan areas.

However, while the cost of health care continues to increase, the benefits and overall value to State employees has decreased. It is also apparent that state employee health insurance no longer provides the competitive advantage it once did. The State of Texas began paying 100 percent of employee and retiree premiums in the late 1980s, and the state began sharing 50 percent of the cost of dependent coverage in FY 1993. Since that time, other large employers have significantly improved the health coverage that they provide to their employees. This has been true particularly during the decade-long economic expansion that ended in 2001. Many large employers now provide dental coverage, vision coverage and other benefits that the state does not provide. Moreover, state health coverage has grown significantly more costly for employees as out-of-pocket costs have ballooned – especially the costs for prescription drugs and the employee share of dependent coverage.

Since the state's health care plan is an attractive feature for employee recruitment and retention, improvements in this area ought to be balanced between savings to the state and costs to the employee. Given the state's current budgetary situation, finding additional appropriations for covering the cost of health care will be difficult. Therefore, it will be important to identify several areas in which the state can lower the costs associated with the health care plan, while seeking to avoid compromises in the current coverage system and the employee's paycheck.

Retirement Programs

The State's retirement system, managed by the Employee Retirement System (ERS), is an added benefit of state employment. The State has a Defined Benefit Plan for employees, elected officials, law enforcement officials, and members of the judiciary. The retirement trust fund totals $17 billion, and has no unfunded liabilities as of August 31, 2002. ERS supports the nation's 55th largest pension fund and the 33rd largest public pension fund. The plan has 149,956 active members as of August 31, 2001. Additionally, there are 47,392 retirees and beneficiaries. As of August 31, 2002, active members grew to 150,313, with retirees and beneficiaries increasing to 50,514. Currently, the state matches an employee's contribution at a rate of 6%, with the employee becoming fully vested at the end of his or her fifth year of service.

As of September 2001, ERS has paid out a total of $865.4 million in retirement benefits. The 77th Legislature authorized a standard annuity multiplier increase from 2.25 to 2.3 percent for each year of service credit.

The ERS saw a negative rate of return on investments of (-7.17%) for FY 2002, but the trust fund remains actuarially sound and maintains a 3.55% five-year return on investment (ROI) and a 7.31% ten year ROI despite the current loss. Poor rates of return are offset by ERS amortizing the dividends from high gains in the mid- to late 1990s. Likewise, ERS amortizes any liabilities over a period of years as well. ERS reports that its investment returns slowed due to the bottoming out of the technology market over the past two years, as well as the aftermath of the events of September 11, 2001.

The state also offers, but does not contribute to, a Defined Contribution Plan wherein employees have the option of contributing pre-tax dollars to the **Deferred Compensation-Texa$aver** program. Comparatively few employees participate in the program – it has only 62,197 participants in the TexaSaver program, with assets totaling $926 million as of May 2002.

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Workforce Planning

As was noted in the employee retirement section, the state could lose a substantial portion of its workforce to retirement, with 16% of employees eligible to retire in the next five years. The fact that 13% of the workforce is over 55 years of age begs the question of the need for agencies to find qualified replacement personnel. Moreover, the high turnover rates among employees under 40 with less than two years experience means that the potential pool of intra-agency replacements is spiraling downward. When these factors are combined with the general perception that the state does not have competitive salary levels, the need for effective workforce planning becomes abundantly clear.

Any workforce planning efforts will require a more nuanced focus than many of these same efforts that were offered in the past. The difference is the nature and magnitude of several changes within the state's population over the past decade. For example, Texas' population grew from 16 million to nearly 21 million residents in the past ten years, with a population total expected to exceed 32 million residents by 2030, according to the State Comptroller's office. The demographics of the State have changed as well, with over 32% of the state's population being of Hispanic origin. As the population of Texas changes, the composition of the state's workforce will change accordingly.

Another rapid change has been the increased use of technology in the workplace, and the subsequent demands for educated, highly-skilled employees. Thus, these changes and their effects on the Texas workforce must be addressed quickly and capably, or it is possible that the state's overall ability to deliver services could diminish. To prepare for these changes, many agencies have begun their own processes of identifying and addressing workforce development and planning issues. Each agency must develop a plan to address:

- Staffing projections
- Areas or programs experiencing the greatest loss
- Staff training, professional development, and education
- Compensation
- Redesigned work processes
- Emerging and existing technology applications and demands

The Texas Government Code requires agencies to conduct a strategic planning analysis as a means of addressing these workforce issues. The State Auditor's office created a Workforce Planning Tool Kit for agencies to follow that helps in the strategic planning process. Recently, state agencies prepared and submitted their respective strategic plans to the State Auditor's office for review and consultation.

Training and Development

Training and development resources have become increasingly necessary to state agencies as they seek to integrate better systems of organizational development and efficiency as well as to enhance the overall work experience of all state employees. Currently, agencies are using their training and development resources to increase overall productivity, raise employee morale and individual job satisfaction, decrease turnover, and enhance quality of life issues within the work environment.

While these training and development resources are very valuable, they are also becoming increasingly scarce. Specifically, each agency must use its own existing funds to develop a targeted training budget. Thus, larger agencies have greater resources at their disposal to invest in training programs, while smaller agencies may find themselves unable to develop adequate programs due to a lack of funding.

Beyond the dilemma of individual budget constraints, each agency has its own specific training needs and requirements. Some agencies implement training and development programs based upon the needs of the agency or upon the particular types of services that the agency provides. For example, the Texas Department of Criminal Justice (TDCJ) requires new officers to complete 288 paid training hours at a vocational academy. Meanwhile, human service agencies such as Mental Health and Mental Retardation (MHMR) provide training based on the specific types of service delivery program.

An unfortunate downside to the agency training process is that once an employee has completed the training program, there is a high possibility that he or she will leave the agency soon thereafter. As a result, agencies are losing time, money and other resources. The most important loss, however, is the growing number of qualified employees leaving their jobs and taking their expertise, training, and knowledge of institutional history with them.

In 1981, Governor Bill Clements founded the Governor's Center for Management and Development (GCMD) in an effort to reduce employee turnover, and to offer qualified personnel from each agency the opportunity to develop greater leadership skills via training and education.

The GCMD courses are offered through the LBJ School of Public Affairs and are tailored for upper level agency employees such as Executive Directors, Division Directors, Managers, and Supervisors. The mission of the program is to train the enrollees in the latest developments in effective management techniques and practices and to educate them further about the unique roll of resourceful leaders in the public sector. The goal of the GCMD is to prepare state employees to manage organizations that will operate in an efficient, effective, and client-oriented manner.

In addition to the GCMD program, the Department of Human Services (DHS) provides internal courses for state employees seeking higher levels of responsibility within their respective departments. After each course is completed, every employee returns a class evaluation form that provides the DHS with immediate feedback concerning the clarity of the presentations and study materials as well as their personal impressions of the efficacy of the course itself.

PART TWO: OPTIONS FOR CONSIDERATION

Compensation Options:

Recommendation for Annual Pay Raises: Given the significant disparity between actual state employee salaries and salaries offered by other employers for comparable work, the legislature should fund annual pay increases for state employees which, at a minimum, would account for increases in the Consumer Price Index (CPI) in the most recent year available. Annual increases in pay are an important retention tool – the impact of which cannot be underestimated. In addition, these increases help to offset rising health insurance costs that must be paid by the employee. Over time, annual pay increases should enable the state to decrease the competitive salary gap to a reasonable level. **Fiscal Impact:** (See table below)

2004-05 Biennial Costs for State Agency Employee Pay Raise Proposals, in Millions

Scenarios - 2004 Increase, then 2005 Increase	All Funds	General Revenue and General Revenue - Dedicated Funds
2.6% then 2.6%	$438.5	$285.3
1% then 0%	$112.8	$73.4
0% then 1%	$57	$37.1

The State Auditor's Office has offered the following recommendations for improving the State compensation system:

State Auditor's Office Recommendations

Employee pay increases:

* Award 2.1% Cost of Living increase in the second year of the biennium for Schedule A and Schedule B. **Estimated Cost: $103 million**

* Update Schedule C in the second year of the biennium to make law enforcement salaries more competitive. **Estimated Cost: $6 million**

* Establish a performance award fund for agencies meeting specified performance standards. Agencies could then grant a one-time performance award to high performing employees. **Estimated Cost: $14 million**

* Encourage agencies to use the merit and one-time merit increase programs available. **Unfunded at this time. Agencies must use their existing budgets.**

Compensation System Technical Changes:

* Eliminate salary steps and expand ranges for Schedule A. **No fiscal impact.**

* Modify some salary ranges of Schedule B. **No fiscal impact.**

* Eliminate dual salary schedules. **Impact to be determined on a per agency basis**.

* Reallocate job classes with salary ranges significantly behind the market. **Estimated Cost: $472,000 for the biennium**

* Make routine maintenance changes to the Position Classification Plan (deleting job classes) **Estimated Cost: $185,000 for the biennium**

Statutory Changes:

* Modify current reallocation language to provide flexibility for agencies when moving employees within salary ranges.

* Increase maximum amount for employee incentive program awards from $50 to $100.

* Grant additional authority to move employees' salaries within their salary ranges for reasons other than performance, such as market conditions.

Insurance Cost Savings Options:

*(The following numbers provided by ERS are **Biennial Estimates** based upon last year's enrollment and coverage levels and are subject to change.)*

Restructuring of the Uniform Group Insurance Program:

* Eliminate Health Select Plus (HSP) entirely: **Savings $80.7million**

Enrollment/Eligibility Changes:

* Introduce a **Waiting Period** that stipulates new State Employees must wait for a to-be-determined period of time before they can receive Health Insurance for FY 2004-05.

Number of Days in Waiting Period	Monetary Savings to State
30 days	$20.9 million
60 days	$41.1 million
90 days	$60.4 million

* No retiree coverage for members not contributing at retirement:
  * Future Retirees: **Savings: $7.2 million**
  * Include Active Retirees: **Savings: $63.8 million**

* No state contribution for board members (approximately 3000 members to date): **Savings: $33.6 million**; 50% contribution for board members: **Savings: $16.8 million**

* 50% contribution for part-time employees: **Savings $19.4 million**

* Index State contribution for dependent coverage based on employee compensation (affects Schedule A, Group 14 and above; Schedule B, Group 6 and above; Schedule C, Groups 2 and above):
  * Reduce State Contribution to 40%: **Savings: $46 million**
  * Reduce State Contribution to 30%: **Savings: $91.9 million**

* Index State contribution for retirees to length of State service (50% for 10 to 15 years of service; 75% for 15 to 20 years of service; 100% for over 20 years of service):
  * Future Retirees: **Savings: $9.8 million**
  * Include Active Retirees: **Savings: $87.1 million**

Premium Contributions from Members:

* Require employee to contribute a portion of the cost of employee coverage.
  * $10/month **Savings : $66.1 million**
  * 5% **Savings: $120 million**
  * 10% **Savings: $240 million**

NOTE: The state's policy of contributing 100% of the employee's insurance coverage has resulted in 100% participation by state employees as well as contributing to the success of the Uniform Group Insurance Program. ERS notes that changes to this policy can have an adverse effect such as:

- *Participation rates dropping, especially for younger, healthier employees*
- *Adverse Selection – People who perceive themselves as healthy or not truly needing insurance will drop out of the program. The result will be that only the sick will be left in the program.*
- *Selection Spiral – As the number of healthy people decreases, and the number of sick people increases, the overall program costs will increase and the sick will pay higher insurance premiums.*
- *Financial integrity loss*
- *Demands for optional plans*
- *Both State and employee costs continuing to increase each biennium*

Benefit Design Changes:

- Increase office visit co-pay
  - $20/visit - **Savings: $70.0 million**

- Charge additional co-pay for specialist visit
  - $10 more - **Savings: $50.2 million**

- Impose $100/day inpatient co-pay : **Savings: $35.0 million**

- Impose $100 outpatient facility co-pay: **Savings: $10.0 million**

- Emergency Room co-pay from $50 to $75: **Savings: $3.4 million**

- Ambulance co-pay for Health Select Plus and HMOs from $0 to

$100: **Savings: $500,000**

- Increase Health Select (HS) co-insurance percent change 85% with $750 network/$1500 non-network out-of-pocket maximum: **Savings: $22.5 million**

- Increase Health Select maximum out-of-pocket from $500 to $1000, for network and from $1500 to $3000 for non-network: **Savings: $28.4 million**

- Deductible increase for Health Select
  - In-network to $100: **Savings: $9 million**

- Mandatory Generic Prescription Drug Program: **Savings: $4.4 million**

- $50.00 Drug deductible for HS, HSP, and HMO (no change in co-pays): **Savings: $18 million**

- Revised HS Drug Benefit (no co-pay)-Deductible/Co-insurance/Co-insurance stop/loss of $200/80%/$1000: **Savings: $9 million**

* Offer a **Defined Contribution Plan** for health insurance: Simply, a consumer driven, self-defined plan for insurance.

* **Matching TexFlex Funds:** As a further incentive for recruitment and retention, the state could match employee contributions to TexFlex at any level up to a maximum of $5,000 per year. In addition to being able to use state matching funds for programs currently associated with TexFlex (primarily various medical savings accounts), an employee would be able to use these funds for important family-oriented programs such as child care and elder care. The ERS staff made the following program cost estimates based on May 2002 overall enrollment in the ERS TexFlex programs:

Type of Program	# of Employee Participants	Amount Contributed by Employees	Cost of a 50% State Match	Cost of a 100% State Match
Dependent Care Reimbursement Accounts	2,419	$704,604	$352,302	$704,604
Health Care Reimbursement Accounts	17,846	$1,803,463	$901,732	$1,803,463
Totals	**20,265**	**$2,508,067**	**$1,254,034**	**$2,508,067**

The above figures take into account participation only by those currently using TexFlex accounts. Of course, the overall cost would rise as the number of participants increased. It is possible, however, that some of those costs could be offset by the nature and function of the program itself. Specifically, all payments into the TexFlex accounts are funded by an employee's pre-tax dollars. Therefore, when employees use pre-tax dollars to fund their TexFlex accounts, there is a reduction of the total taxable employee income, thereby reducing the total payroll numbers. The result would be a corresponding reduction in the contributions required of the state toward Social Security taxes. Thus, a certain amount of the aforesaid cost could be offset by savings the state could realize via reduced contributions to these other benefits. At the present time, there are no state matching funds appropriated for this program.

Retirement Benefits Options:

* **Increase Annuity Multiplier:** As a means of boosting the state's ability to remain competitive in the market, the annuity multiplier could be increased by a small percentage. The rate is currently set at a 2.3% increase for every year of service. As an option to consider, the multiplier could be raised to 2.5%. It is estimated that raising the multiplier .02% would cost the state approximately $75 million as estimated by ERS or up to $155 million as estimated by the

Legislative Budget Board. However, the additional costs incurred by increasing the multiplier may not be the best means of using scarce state resources because this action would primarily benefit only long-term, career employees. Based on demographic data, employees with at least 10-15 years experience with the state have a turnover rate of less than 10%. And given the fact that the highest turnover rates occur among employees with less than two years of service with the state (52%), raising the multiplier may not appear to be an effective means of diminishing employee turnover.

* **Rule of 80 Requirement:** The state could review changing the current "Rule of 80" requirement for state retirement benefits. Currently, an employee may receive full retirement benefits when the number of years of state service plus the employee's age in years equals 80. If the target number were reduced to 75 instead of 80, employees could retire earlier, thereby reducing high-end payroll expenses and offsetting some of the costs of this proposal. ERS staff estimates the cost to be approximately $95 to $105 million per fiscal year. Of course, these numbers would be contingent upon the actual size of the state employee payroll. The above costs account for the actuarial requirement that the state increase its contribution to the fund from the current rate of 6% of payroll to 8.1%.

Quality of Life Options:

***Coordinated Career Counseling**:

An issue that arose during an Employee Compensation Task Force meeting was the perceived lack of career advancement opportunities for state employees and the subsequent effects of this perception on employee turnover. Primarily, state employees do not adequately understand the classified salary structure itself, and consequently do not understand how they may move up within the salary structure. This lack of professional direction contributes to the perception that a state job is a dead-end job. Consequently, the state's best employees will flee oftentimes to the private sector and ultimately add to the already high turnover rates.

In an attempt to remedy this situation, it may be helpful to provide specific career advancement resources to state employees that would be similar to resources provided by the Texas Workforce Commission to the general population. In effect, state employees would have access to professional career counselors equipped with the necessary resources required to assist the employees in making informed decisions about possible career opportunities and advancement within the framework of the state government. It thereby follows that these structured counseling and information-sharing practices could increase employee retention rates by showcasing the benefits of continued state service, encouraging state employees to consider specific state jobs rather than similar private sector jobs and aiding those employees in finding jobs that could satisfy their professional goals.

In addition to providing assistance to employees, this program would provide collateral benefits to the HR departments of each agency. Specifically, the career counselors will have been able to screen the credentials and interests of many employees already familiar with agency procedures. And since the counselors would remain apprised of the personnel needs of each agency as well, they would be in a strategic position to serve as liaisons between agencies seeking personnel and the employees seeking positions. This centralization and coordination of efforts could dramatically reduce the turnover time per position, as well as lessen the hit-or-miss nature of the agency hiring process.

* Increase use of **Flex Time**, **Four Day Work Week**, and **Tele-commuting**

* **Employee Recognition Day** – Last year, the state did have a date set aside for employee recognition, but it was not observed.

* **Branding and Imaging** – Create a public relations campaign focused on reaching out to existing employees and possible new employees. The campaign would use a variety of media formats such as the State Auditor's Office website, the Texas Online website, video, and various pop-up computer messages. The State Auditor's Office has suggested enlisting the Governor to deliver messages of appreciation to existing employees on a periodic basis. These messages also would be an indirect means of appealing to the general public and informing them of the benefits and opportunities that are available for those employed by the state government.

Independent Assessment Option:

Consecutively from 1994 to 1996, the Texas Research League (later named the Texas Research Foundation) performed a comparative compensation analysis ***at no cost to the state***. This is an option that could be considered once again so that both the legislature and the agencies might have an independent assessment of the state's salary structure and its market competitiveness or lack thereof. This assessment would include an analysis of the salary ranges as well as a comparison of actual state employee pay/salaries to those of the market.